Weekly Updates Issue # 592

1. Weekly Markets Changes

[November 25, 2016]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
15,075.44 +211.4 +1.42%	2,213.35 +31.45 +1.44%	19,152.14 +284.2 +1.51%	5,398.92 +77.41 +1.45%	$0.7390 -0.16¢ -0.22%	$1,183.40 -23.90 -1.98%	$45.96 +0.38 +0.83%

2. Ottawa's deficit for September doubles compared to last year

[November 25, 2016] The federal government ran a $2.4-billion deficit in September, double the $1.2-billion deficit set in the same month last year.

The Finance department says the bigger shortfall was due to a combination of lower revenue and higher program spending.

Revenues in the month totalled nearly $21.7 billion, down from nearly $22 billion in September 2015, due to lower corporate income tax, non-resident income tax and excise taxes and duties.

Program spending grew to $22.2 billion, up from $21.2 billion a year ago, due to increases in major transfers to persons and other levels of government.

Public debt charges fell to $1.8 billion from $2 billion.

For the first half of the government's fiscal year, it ran a deficit of $7.8 billion compared with a surplus of $1.6 billion in the same April-to-September period last year.

The government has forecast a $25.1-billion deficit for this fiscal year, which ends March 31.

3. The Child Benefit isn't boosting retail sales

[November 25, 2016] In July, Prime Minister Justin Trudeau's government sent enhanced payments worth hundreds of dollars to more than 3 million households. The Finance Department says the Canada Child Benefit will result in increased monthly incomes for nine of 10 families that previously received federal contributions. Recipients will collect an average increase of $2,300 in the 2016-17 benefit year, according to Finance.

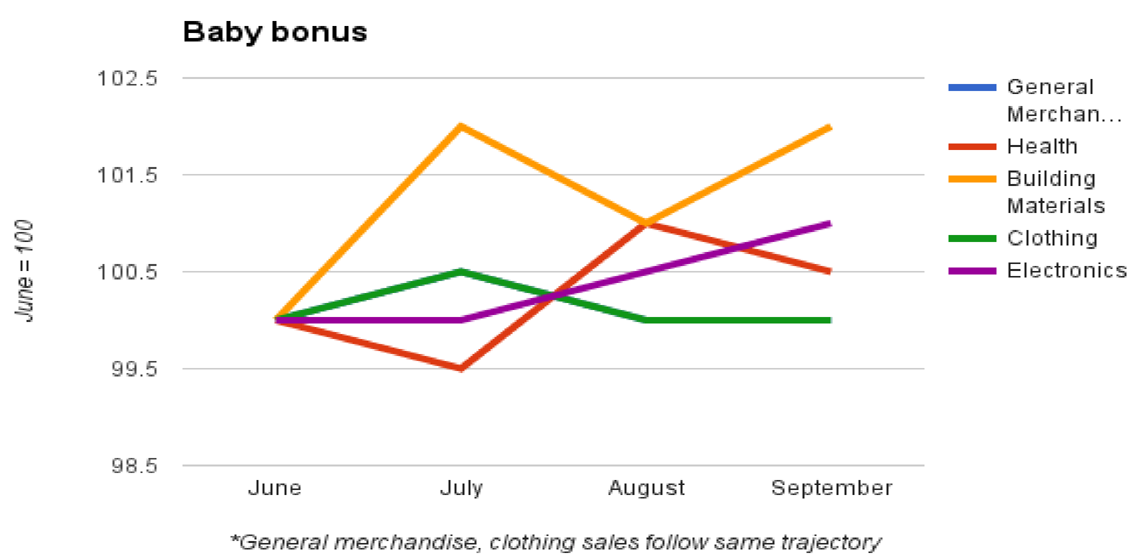
Trudeau never really talked about his overhaul of the family benefit program as economic stimulus, but that didn't stop others from anticipating a jolt in household spending.

"The rollout of the Canada Child Benefit is anticipated to start providing additional support to household spending in the second half of 2016," the Bank of Canada wrote in its latest quarterly report on the economy. There now is enough data available to make an early assessment of those hopes. Anyone who thought heavily indebted households would take the money and run to their nearest malls will be disappointed.

Retail sales increased 0.6% in September from August, the first gain in four months, Statistics Canada reported on November 22. Seven of eleven categories posted higher sales, yet the stronger headline number was almost entirely the result of a surge in purchases of new cars. Otherwise, the increases were broad, but tiny.

Automobile sales don't tell us much about the stimulative effect of the Child Benefit payments. They probably have more to do with the level of interest rates and manufacturers' discounts. Sales at gasoline stations rose 0.9%, but that had more to do with higher oil prices than stronger demand. To get a sense of whether the Benefit checks are affecting demand, one must look at discretionary spending.

That picture looks something like this:



Those lines represent change in the five biggest retail categories since June, excluding automobiles and gasoline stations. There was upward movement, suggesting the Child Benefit will provide some economic support in the months ahead.

Still, these aren't big changes. At $5.6 billion, sales at general merchandise stores were about $100 million higher than in September than a year earlier, but essentially unchanged from June this year. "The underlying trend in Canadian retail sales remains lacklustre," said Nick Exarhos, an economist at CIBC World Markets in Toronto. "That's disappointing, given the recent stretch of healthy employment gains, and the fact that some families have been receiving enhanced cheques from Ottawa since July."

To avoid further disappointment, it might be necessary to stop expecting much of a pop in gross domestic product from the Canada Child Benefit.

That's not an argument against the program, however. Consider "Samantha," the Victoria-based single mom who makes an appearance in Finance Minister Bill Morneau's autumn fiscal update: Samantha makes $30,000 a year. And, according to the update, she will use the extra $533 per month she is receiving in family benefits to buy her four-year-old son some school books, register him in swimming lessons, and increase contributions to her son's Registered Education Savings Plan.

Trudeau, Morneau and others in the government have been clear that their tax cuts and benefit enhancements are primarily about relieving anxiety, not driving demand. As recent events in the United States attest, that is a worthy policy goal. Short-term economic stimulus will have to come from somewhere else.

4. Where to look as U.S. rates rise

[November 24, 2016] Now isn't the time to buy securities like 30-year U.S. Treasuries, which were yielding a little over 2.5% at the end of October, says Ignacio Sosa, director of the product solutions group at DoubleLine Capital in Los Angeles. (As of November 21, 30-year U.S. Treasuries were yielding around 3%.)

"The level of yield that the investor is getting per duration is almost at the lowest of all time," he explains. "So you're getting paid less to take on more risk. [Buying those securities] only makes sense if you believe interest rates are going to stay this way, or fall forever."

And that's unlikely, says Sosa, whose firm manages the Renaissance Flexible Yield Fund. "Interest rates in the U.S. have seen their lows," he predicts. "The 10-year U.S. Treasury is likely to see a 2% rate towards the end of this year.

It will then go up steadily, gradually." This is all the more likely now that the U.S. Federal Reserve has strongly hinted a rate hike is coming in December.

So, he says, "To be buying securities like [those] doesn't sound attractive to us. If you want to stick with government risk, you're much better off buying TIPS, or Treasury Inflation-Protected Securities. That's a better way of recognizing that [interest] rates could go up [and] inflation could go up, and to not take the risk of going much further out on the duration scale at very low yields."

Other opportunities in the securitized space

Many U.S. banks are "withdrawing or retreating" from the securitized asset space, due mainly to tighter regulations, says Sosa.

"I'm thinking of the commercial mortgage-backed securities market, for example, as there are [are many] commercial real-estate loans that are coming due, or [that] have come due this year, and the banks are unable to renew these loans. Or, in the case of a new lender, to make a new loan because of Dodd-Frank and other regulations," says Sosa.

This provides an opportunity because "these are very attractive securities," he adds. "Generally you're lending about 70% of the value of a building. So you have quite a bit of room for the building to come down in price; if it were to go down in price, you'd still be protected."

Also, consider that commercial real estate prices dropped significantly after the 2008 market crash, and have only recovered to near their old levels in major cities like New York, Los Angeles and San Francisco so far. "The United States has commercial real estate in many other cities that are still way below their highs. So, we think that this is a very attractive asset class," says Sosa.

In addition to commercial mortgage-backed securities being undervalued, Sosa adds, "they've proven to be more resilient than corporate bonds. We think [they] offer a much better risk-return profile than corporate bonds."

Residential mortgage-backed securities also look promising, says Sosa. If you look at "mortgage loans that were extended prior to the crisis, they have survived the worst already. The only things that would [significantly] impact them going forward would be a dramatic recession, much higher unemployment [and] a much greater fall in housing prices."

And he's not forecasting a recession in the near term. He adds, "For housing prices to fall substantially from here—[given] they haven't yet recovered to 2007 levels in a lot of markets—you would need quite a bit of [a] shock to the system."

In particular, residential mortgage-backed securities are attractive because they're less sensitive to interest rates, says Sosa. Further, "even when credit products like corporate bonds fell out of favour last year, up until February, residential mortgages [remained] pretty stable."

5. Emergency funds non-existent due to mortgage, retirement challenges

[November 24, 2016] An emergency fund is meant to be there in times of need, but a new survey suggests nearly half of Canadian homeowners would be ill-prepared for a personal financial dilemma such as job loss.

The poll released by Manulife Bank found that 24% of those surveyed don't know how much is in their emergency fund, 14% admit to not putting away any funds and 9% have access to $1,000 or less.

The remainder of those surveyed have up to $10,000 saved, with the average amount being $5,000.

Millennial homeowners (those aged 20 to 34) report the lowest median amount of emergency funds — $3,500.

"The risk here is when they don't have that money, and an unexpected event happens like you need a new furnace or a car repair, many of these people don't have a choice but to lean on high-interest cards," says Manulife Bank chief executive Rick Lunny.

Instead of taking advantage of the current low-interest rate environment to save money, Lunny suggests many homeowners are using low rates to buy more expensive homes.

"They've taken on large mortgages, and, as a result of that, they're stretched in many ways," he says. "Because of that, maybe they haven't had the financial discipline to put aside rainy-day money."

However, almost half of millennials and Gen Xers (those aged 35 to 51) are using low rates to accelerate debt repayment, while just one third of Baby Boomers (52 to 69) are doing so, reveals the survey.

Mortgage mayhem

Among those polled, homeowners had an average of $174,000 in mortgage debt, with an average of 28% of their net income going toward paying off their homes each month.

About half (46%) of those polled say they would have difficulty making their monthly mortgage payments in six months or less time if their household's primary income earner lost her job.

If interest rates cause their mortgage payments to increase, 16% say they would have financial difficulty.

Only a third of mortgage holders say they could manage a mortgage payment increase of up to 10% without encountering any financial difficulty.

According to Manulife Bank's mortgage calculator, a homeowner with a mortgage balance of $174,000, an interest rate of 2.89% and a 20-year amortization period would have monthly payments of $954. The interest rate would need to increase by just over one percentage point for payments to increase 10% to $1,049 per month.

Mortgage data has been a hot-button topic in recent months, as the federal government takes steps toward reducing the risks in the Canadian housing market, particularly in Toronto and Vancouver.

Earlier this month, Finance Minister Bill Morneau announced that stress tests will be required for all insured mortgages to ensure that borrowers would still be able to make their mortgage payments if interest rates rise or their financial situations change.

The average chartered bank's posted five-year fixed-mortgage rate was at 4.64% in June, a 40-year low, according to Statistics Canada. (By comparison, the rate was 21.75% in September 1981.)

Last year, Ottawa raised the minimum down payment on the portion of a home worth more than $500,000 to 10%.

Lunny applauds the changes but says it doesn't change the financial situation of current homeowners, who may already find it difficult to make mortgage payments.

Retirement realities

Home ownership could be crucial to many Canadians' retirement plans.

For boomers, 22% indicate their homes will represent more than 80% of their wealth when they retire, and a further 18% say it will represent between 61% and 80% of their wealth.

Only a third of Gen Xers express confidence in their ability to maintain their lifestyle in retirement, compared to 41% for millennials and 45% for baby boomers. Not being able to save for retirement was noted as the top source of stress for Gen Xers (41%).

But financial concerns don't end when retirement arrives.

Research from HomEquity Bank reveals almost half of those who identify themselves as retirees have outstanding debt, and 40% report savings of less than $100,000. Further, a quarter of those aged 75 or older still have a mortgage.

Overall, 35% of Canadians 75 or older have debt.

Manulife survey participants were aged 20 to 69, with household incomes of $50,000 or more.

6. How currencies are doing post-election

[November 22, 2016] Build walls and slash taxes. It sounds like economic balm.

But there's a dark side to protectionism, infrastructure spending and tax cuts, warns Luc de la Durantaye, head of asset allocation and currency management at CIBC Asset Management: inflation.

Inflation will prop up the U.S. dollar, which is already overvalued, he says. And the Federal Reserve will have to raise rates to manage inflation—with a December hike a foregone conclusion, according to the CME Group's Fed fund futures tracking tool.

"We've got to think about the feedback loop," he says. "There cannot continually be a rise in interest rates and strong U.S. dollar. That tightens financial conditions and makes life for corporations and consumers tougher."

That being said, de la Durantaye has a "large long U.S. dollar position." But he's watching the allocation. "We're monitoring the level of yields and steepness of the curve." His target for the U.S. 10-year Treasury is between 225 and 250 basis points. Beyond that, "as the U.S. dollar strengthens and yields continue to rise, the U.S. equity market will start buckling down."

When yields peak, "that will be the sign [for us to] start lightening up on the U.S. dollar. And depending on how much the emerging currencies have corrected, then we would go back in bigger percentages to some of our better-ranked and higher-yielding currencies."

BoC welcomes low loonie

Bank of Canada deputy governor Timothy Lane drew the interest of market strategists after recently stating that Canada doesn't need to follow the Fed and noting the positive effects of a weaker Canadian currency.

"The dollar has been weaker since Trump was elected, so you can see they're not concerned about it," says Luc de la Durantaye of CIBC, explaining that if the BoC makes such statements when the dollar's already weak, "they're implicitly embracing it."

Stephen Lingard of Franklin Templeton Solutions visited Alberta last week and sympathizes with the BoC's position, saying, "We're seeing near-recessionary conditions in some parts of the country."

While he's not ready to do this yet, "there's a limit to how much the dollar can rally and yields can rise. There's a limit to how much fiscal spending can add in terms of growth. And the higher the inflation, the lower [a company's] price-earnings [ratio]. So that trade-off is just putting a cap on equity markets, which will put a cap on the dollar."

Stephen Lingard, senior vice-president and portfolio manager, Franklin Templeton Solutions, warns that "some of the inflation emerging is underappreciated, so we get more protection holding inflation-protected securities. We're leaving that exposure unhedged, as well as U.S. investment-grade securities."

But Lingard has begun to hedge other fixed income in his multi-asset portfolios back to the Canadian dollar. "We're [about] 50% hedged on fixed income," he says. "Our most conservative strategy has 75% Canadian dollar, and as much as 15% U.S. dollar risk. We'd hedge back another 5% of that."

The reason? The Canadian dollar could still weaken, but "we're recognizing we're seven or eight innings in this weakness, and we're adding back some hedges on a gradual basis. We'd never put all our hedges back on at once."

More on the loonie's direction

Lingard sees the Canadian dollar "range-bound" to $1.35 per U.S. dollar. His research has shown that "when the Fed begins to raise interest rates, that tends to mark the peak in the U.S. dollar." That's because global growth has likely improved, and the U.S. dollar is no longer needed as a safe haven, he hypothesizes.

De la Durantaye's call for the loonie is between $1.37 and $1.40 per U.S. dollar. "You might get an undershoot of the Canadian dollar that would be related to an overshoot on the U.S. dollar," he says. "That would be a place where the Canadian dollar would stop depreciating." He says this in part because he doesn't think oil prices will go below US$40.

He adds that oil producers have been ramping up in anticipation of an OPEC output agreement on November 30. He says oil has become a more competitive market, with the supply curve flattening out. "Production will adapt a bit more naturally. That means oil prices will be less volatile than historically." He sees a range of US$40 to US$60 per barrel, instead of US$30 to US$90.

So far, the effects of stronger oil on the CAD have been muted. "That suggests there may be some underlying strength in the U.S. dollar absent that," Lingard says.

World currencies to watch

Lingard's mainly unhedged in equities, except for Japanese stocks. "We have a positive view on Japanese equities, but we do not want the currency exposure," he says. "We're hedging out over half of that yen exposure. That's the only way the asset class makes sense to us."

As for emerging markets bonds and stocks, "those are very difficult to hedge," says Lingard. "It's very costly, sometimes there aren't even contracts." So while he's mostly unhedged, he manages the exposures. He notes that while the JP Morgan Emerging Market Currency Index is down about 4% since November 8, it's up 10% since the beginning of year.

As for de la Durantaye, he likes the Brazilian real, Colombian peso and South African rand because they're high-yielding currencies relative to the loonie. Despite some corrections post-election, "over time, you can still get a higher return if you hold them for a period of six to 12 months," he says. That's in part because Brazil has fewer trade links to the U.S. than Mexico and other countries. And Colombia is readjusting to lower oil prices more quickly than Canada, due to its lower production costs.

"Asian currencies are at risk, particularly the lower-yielding ones with [U.S.] trade [being] important to them," de la Durantaye says. He cites China, Korea, Taiwan and Malaysia as "most at risk." He's also concerned about the Singapore dollar, given that the economy is trade-oriented.

Like Brazil, currencies in economies that are sheltered from the impacts of U.S. trade protectionism—such as India and Indonesia—should fare better.

7. One solution for Canada's low productivity, demographic issues

[November 22, 2016] Canada's GDP would get an annual boost of $27.7 billion if barriers were removed to ensure indigenous people can participate in the economy, says the National Aboriginal Economic Development Board in a new report.

The group's latest report, to be released Tuesday, says equal economic opportunity for indigenous peoples would help Canada address ongoing economic challenges caused by low productivity and demographic pressure from an aging population.

It also notes the productivity of Canada's Aboriginal Peoples would match that of their non-indigenous counterparts, if they received the same level of education and training. The report says an additional $8.5 billion in income could be earned every year by the indigenous workforce if education and training gaps are closed.

For example, it suggests B.C. could stand to benefit to the tune of $1.4 billion a year in additional income earned by more than 125,000 workers, while Ontario could bring in an additional $2 billion through more than 169,000 workers.

The board says the indigenous labour force is underutilized, despite the fact the indigenous population is young and growing fast.

Dawn Madahbee Leach, the board's interim chair, says economic development can also assist in reconciliation efforts. "I can tell you first-hand, when somebody is provided with a job, they are able to provide for their

families with regards to basic needs like shelter and food and then they become a role model for their children."
She adds, "This report deals […] with helping our people to help themselves through employment, through education and training."

8. Where Canadian oil will be 10 years from now

[November 22, 2016] Analysts have a bullish outlook for Canadian crude over the next decade as new pipelines come online and oil prices slowly edge up.
The Justin Trudeau government has less than a month to issue a decision on Kinder Morgan's proposal to expand its Trans Mountain pipeline from Alberta to the Pacific Coast, which would open an export terminal to Asia and nudge up Canadian crude prices on higher demand.
The controversial Trans Mountain expansion is facing regional and environmental opposition—with Vancouver Mayor Gregor Robertson saying it will draw "protests like you've never seen before"—but analysts see it going through. Skip York, vice-president of integrated energy for Americas research at Wood Mackenzie, sees the expansion operating by 2019 or 2020.
The expanded Trans Mountain pipeline could ship 750,000 barrels per day, he says, and another million barrels per day could come online from the proposed Energy East link to the Atlantic Coast sometime between 2025 and 2030.
"If we get oil back to US$80 per barrel, and access to global markets through the Trans Mountain expansion, the combination of those two really creates a healthy environment for Canadian Oil Sands" York says.
A barrel of Western Canadian Select, an index for Canadian crude, trades at a discount from a barrel of the U.S. benchmark, West Texas Intermediate. (The discount has been about US$15 in recent months.) That's partly because almost all Canadian oil exports go to the U.S.
Proponents of the Trans Mountain expansion say it would provide a "netback price" premium of US$2 to US$4 per barrel as Canada's export market is diversified. That would come as crude oil prices globally are expected to slowly pick up over the next 10 years.
"You can put all the Teslas you want on the streets of Toronto. That's not going to make a difference to the oil demand," says Tim Pickering, founder and lead portfolio manager for Auspice Capital in Calgary, which offers a Canadian crude oil ETF that tracks prices.
He says emerging markets will help with rising oil demand. "Forget peak oil, it's peak demand. When's peak demand? It's a long way off," Pickering says.

Even as energy efficiencies slow demand in developed economies, York expects oil to settle at about US$80 per barrel between 2020 and 2025, adjusted for inflation. (In nominal prices, a barrel may cost above US$100.)

McKinsey & Company said earlier this year that European and North American energy demand will decline through 2050 as emerging and developing countries drive demand. The firm predicts total oil demand growth to nearly flatten to 0.4% in 2025.

By 2030, electric vehicles, including hybrids and battery-powered plug-in vehicles, may be close to 50% of new cars sold in China, the EU and the U.S., or about 30% of new cars globally, McKinsey says. Ark Invest, an investing firm, forecasts that oil demand will peak by 2025. It forecasts demand to then decline to 90 million barrels per day by 2035.

Pickering says the Keystone XL pipeline project—which could get back on track after Donald Trump enters the White House—matters less now as Alberta has more oil storage and existing pipeline capacity to the U.S. has been optimized.

The Keystone XL pipeline is not a "game changer," he says.

9. Wholesale sales fall 1.2% in September: StatsCan

[November 21, 2016] Statistics Canada said Monday the value of wholesale sales fell 1.2% in September to $56.0 billion.

Economists had expected a gain of 0.4% from the previous month, according to Thomson Reuters.

CIBC economist Nick Exarhos noted that the softness was reflected in the volume of wholesale sales, which fell 1.5%.

"We're hopeful that strong retail figures tomorrow make up for some of the lost ground, but it looks like September will be a lacklustre month for output," Exarhos wrote in a note to clients.

"After some strong months, today's release won't change our third-quarter forecast much. But it will mean that the fourth quarter, which is likely the decisive quarter for the Bank of Canada on whether to ease [rates] or not, will get a weak hand-off."

The drop in wholesale sales follows increases in four of the previous five months.

Statistics Canada said wholesale sales fell in five of the seven subsectors it tracks, led by the machinery, equipment and supplies and the miscellaneous subsectors.

The machinery, equipment and supplies subsector posted the largest drop in dollar terms for the month as it fell 4.0% to $10.9 billion, its lowest level since April. The miscellaneous subsector fell 3.1% to $7.0 billion.

Wholesale sales in volume terms fell 1.5% in September.

The results come ahead of retail sales data for September on Tuesday morning and third-quarter growth figures on Nov. 30.

Economists expect the third quarter to show strong growth after the economy pulled back in the second quarter. However, how much of that momentum will carry over into the final three months of the year is unknown.

The weak wholesale sales data follows a report last week that manufacturing sales rose 0.3% to $51.5 billion in September, however sales in constant dollar terms sales slipped 0.2%, indicating a lower volume of goods sold.

Have a nice and fruitful week!