CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

*April 20, 2017*

# Canada and the U.S. on Different Economic Paths

Canada experienced minimal declines in housing prices and household debt during the 2008-2009 global financial crisis. Since then, Canadians have had a large appetite for borrowing. Canada is now experiencing a credit and housing bubble in many regions. In contrast, the U.S. experience during the global financial crisis was severe. The long recovery since then has been characterized by moderate GDP growth. Currently, the policies of the newly elected Republican administration are in the spotlight. In this first quarter (Q1) 2017 edition of our Newsletter, we will examine these Canadian and U.S. economic themes. We will also review our investment activities in recent months, which have followed our familiar strategy of seeking to purchase high-quality assets at a discount.

## Toronto Housing Enters Bubble Territory

In Canada, nothing gets the attention of policy makers like issues affecting Toronto. The Greater Toronto Area now has a population exceeding 6.4 million, and it is the unquestioned economic heart of the country. March 2017 data indicates that Toronto house prices have risen 33% on a year-over-year basis. The average price of a detached Toronto home is now over $1.2 million.[1] On April 18, representatives of all levels of government, including Federal Finance Minister Bill Morneau, met to discuss ways to cool the Toronto housing market. On April 20, Ontario Premier Kathleen Wynne announced a wide range of measures, including expansion of rent controls and a new 15% tax on home purchases by non-resident foreigners in Toronto and surrounding areas.[2] Having experienced B.C.'s last decade in housing, we are not surprised by these developments. It is interesting that changes in the Toronto housing market attract more political attention, but then again, Toronto is more systemically important to the Canadian economy than Vancouver.

## Canadian Credit Concerns Persist

Across Canada, household debt levels have soared along with housing prices over the past decade. As a result, we have concerns about Canadian household debt levels and the risks they pose to financial stability. The ratio of Canadians' household debt to disposable income is now at a record 169.4%. This compares to 99% in 1996.[3] The International Monetary Fund has noted that Canada, along with Singapore and Australia, has experienced the fastest-growing private sector debt since the global financial crisis.[4]

Recently the Bank of International Settlements (BIS) announced that Canada is among the countries showing early warning indicators for financial crises and domestic banking risks. More specifically, the BIS studied countries where there are large increases in credit and housing prices but only moderate increases in gross domestic product (GDP), creating a "credit gap". In other words, a gap is created when credit grows too quickly in relation to the economy. The BIS stated that Canada now has one of the highest credit to GDP ratios among developed nations.[5]

The data is undeniable. Elevated Canadian household debt levels will be a drag on our economic growth over the next decade. At the moment we are not making any material changes to client portfolios based on these concerns. We have already incorporated these concerns into the relative weighting of various sectors and companies, and we are maintaining substantial weightings in U.S. companies. In some cases, we have benefitted from the increases in Canadian credit and housing prices. For example, Canadian Apartment Properties REIT (TSX:CAR.un)[6] has been a strong performer over the last several years, aided by the fact that 33% of its suites are located in the Toronto market.[7] We simply must be aware of the risks relating to unsustainable Canadian credit expansion and invest accordingly. The Canadian banking sector provides an example - we believe the outlook for Canadian banks to significantly increase lending to Canadian households is weakening due to their existing debt levels.

**U.S. Economic Update**

The big picture for U.S. economic growth over the past several years has generally been positive, with the economy growing at a 2.6% rate in 2015 and 1.6% rate in 2016.[8] Recently, the Atlanta Fed estimated that the U.S. economy grew at a annualized rate of 0.5% in Q1, a disappointing pace.[9] Clearly there has been no short-term increase in growth relating to the November U.S. election results, despite positive consumer and business sentiment indicators. The election's impact on longer-term growth is yet to be determined, and will ultimately depend on the quality of the policies enacted.

Many investors have been expecting tax cuts, infrastructure spending and deregulation from the Republican administration. Given that the Republicans now control the Presidency, the House of Representatives and the Senate, some investors expect these policy changes to be enacted rapidly.

This may not be possible, due to divisions within the Republican Party. In late March, an attempt to repeal the 2010 Affordable Care Act (Obamacare) failed before making it to a vote in the House. Viewed in isolation, this failure was not very consequential to the stock market; however, it is linked to other policies of the administration. For example, savings anticipated to come from the repeal of Obamacare were expected to help fund tax cuts.

The expected tax cuts for corporations have helped stock market performance, as they would increase corporate earnings. Some commentators have noted that America's 35% corporate tax rate is the highest in the industrialized world. In addition to general corporate tax cuts, the Republican administration is considering a one-time repatriation of corporate profits held offshore at a 10% tax rate. American companies now hold approximately US$2.6 trillion of earnings from foreign operations in offshore accounts. It is unclear how much would be repatriated, but any significant amount would add to investment and employment.[10]

These tax cut plans face hurdles. They could cause large deficits that can only be corrected by cutting other U.S. Federal Government spending, 77% of which now consists of Social Security, Medicare, Medicaid, defense, veterans programs and debt interest. In 10 years, those difficult to cut categories are projected to account for 83% of spending.[11] Regarding the divisions within the Republican Party, many Republicans are opposed to large deficits and rapid increases in government debt. A tax cut proposal that is scaled back out of necessity or only includes one-time repatriation measures could disappoint investors. It may take until late 2017 or early 2018 to enact these policy changes, which is a slower timeline than many investors expected.[12]

In summary, the U.S. economy is in a period of moderate growth, which has weakened in the short term, but may accelerate over the coming months with the aid of business-friendly government policies.

**Q1 Portfolio Highlights**

On March 8, we purchased a 2.0% weighting in MacDonald Dettwiler & Associates Ltd. (TSX:MDA) in the Total Return Portfolio at a price of $65.49 per share. MDA is a satellite communications and information company that provides services to governments and private companies. Our purchase was somewhat contrarian, as MDA shares had fallen from $90 to $65 within the past year, making a long-term investment more attractive. When we look at the company's track record, growth potential (especially given its recently announced acquisition of satellite imagery company DigitalGlobe), modest valuation and dividend that is over 2%, we believe it fits the objectives of the portfolio. MDA also contributes to greater diversification within the portfolio, as its business is quite different from the other companies we hold.

Mullen Group Ltd. (TSX:MTL) is one of the largest trucking and logistics companies in Canada. On March 8, we purchased a 1.5% position in Mullen shares for the Total Return Portfolio. Our purchase price was $16.54 per share. In comparison, the shares were trading at over $30 around 3 years ago. Mullen's business has a significant segment relating to specialized oilfield trucking in Alberta. Due to the lower levels of oilfield activity, that segment's earnings have dropped substantially. On the other hand, Mullen's generalized trucking and logistics segment continues to grow, in part fueled by acquisitions of smaller trucking companies. We are buying Mullen shares in the trough of the Western Canadian business cycle in western Canada with a multi-year hold period in mind. Our purchase is somewhat contrarian in nature. The company has a history of being shareholder friendly and paying large dividends. At the moment, the stock yields just over 2%, but dividends could rise substantially if there is an upturn in Western Canadian business conditions.

On January 9, 2017, we purchased a 2.0% weighting in grocery store chain Whole Foods Market Inc. (NASDAQ:WFM) in the Total Return Portfolio at a price of US$30.74 per share. Whole Foods has been at the center of North American consumers' movement towards natural and organic foods. Founded in 1980 in Austin, Texas, the company now operates over 450 stores, mainly in the U.S.[13] Whole Foods stores offer a great selection of premium products and a pleasant shopping experience; however, in recent years, competition has been tough, both from other premium grocery chains and from mainstream grocers expanding into organic foods. Grocery retailing is a business with low barriers to entry, and Whole Foods' brand and shopping experience can only take it so far with price-sensitive customers. In 2013, Whole Foods shares briefly touched US$65. Our purchase price of US$30.74 seems attractive to us, as the valuation of the shares has compressed, and we believe the company will continue to grow its sales and earnings over the next several years. In mid-April, 2017, U.S. activist hedge fund Jana Partners announced that it has upped its stake in Whole Foods. Disappointed with the performance of the shares, Jana Partners intends to agitate for improvements to the business and possibly the sale of the entire company.[14] In the short term, this news has driven the shares over US$35. (Update – On April 24, after the date of writing this Q1 Newsletter, we sold Whole Foods shares out of the Total Return Portfolio at a price of US$37.15 per share.)

In the High Yield Portfolio, we purchased shares of National Grid PLC (NYSE:NGG) at a price of US$57.10 per share on January 10, 2017. National Grid now has a weighting of 2.5% in the High Yield Portfolio. The company's primary asset is electrical transmission infrastructure in the U.K. Recently, sentiment on British stocks has been weak, and the British pound has fallen substantially against the Canadian dollar and U.S. dollar. National Grid had fallen from above $70 down to our purchase price. We expect to collect close to a 5% dividend yield, and the company has also announced that it will pay a special dividend in the near term, as they are selling some natural gas transmission assets. We are very familiar with the company, as it is our third time owning shares in the last seven years within a model portfolio. Each time we have made a good return.

In the Balanced Portfolio, we sold our position in Vermilion Energy Inc. (TSX:VET) at a price of $50.95 on March 6, 2017. We had initially purchased Vermilion in the Balanced Portfolio at a price of $38.99 on March 10, 2016. We have also taken profits on Vermilion in the Total Return Portfolio and High Yield Portfolio over the past year. While we continue to maintain a weighting in high-quality energy companies, the recovery in oil prices has been underwhelming.

## Conclusion

Our philosophy of buying high-quality businesses trading at undervalued prices has proven to be durable through many different environments. We believe that this approach will continue to yield good results for clients over long periods of time. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for reading our Q1 Newsletter, and thank you for your business.

**David W. Papau** *BA, CIM, FCSI*
Portfolio Manager
T: 604 641-4358
david.papau@cibc.ca

**Michael H.F. Armstrong** *BA, CIM, FCSI*
Portfolio Manager
T: 604 608-5223
michael.armstrong@cibc.ca

**Andrey Schmidt** *BA, LLB, CIM*
Investment Advisor
T: 604-608-5224
andrey.schmidt@cibc.ca

CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

## APPENDIX "A"

## DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

---

[1] http://ca.reuters.com/article/businessNews/idCAKBN17J1KF-OCABS?sp=true
[2] http://www.cbc.ca/news/canada/toronto/wynne-housing-market-1.4077094
[3] http://www.canadianbusiness.com/economy/evan-siddall-cmhc-profile/
[4] http://www.macleans.ca/economy/economicanalysis/change-and-pain-are-headed-for-canadas-housing-market/
[5] http://business.financialpost.com/news/economy/bank-for-international-settlements-says-canada-is-showing-early-warning-signs-of-financial-crisis
[6] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
[7] CIBC World Markets, Canadian Apartment Properties REIT Earnings Update, February 28, 2017
[8] http://www.cnbc.com/2017/02/28/second-estimate-of-us-q4-2016-gdp.html
[9] http://www.barrons.com/articles/great-expectations-a-dickens-of-a-problem-1492601824
[10] http://www.marketwatch.com/story/how-us-economic-growth-could-accelerate-to-4-2017-03-23
[11] http://www.marketwatch.com/story/of-course-donald-trumps-tax-cuts-are-in-trouble-2017-04-03
[12] http://fortune.com/2017/04/12/donald-trump-tax-reform-stock-market/
[13] https://www.sec.gov/Archives/edgar/data/865436/000086543617000049/wfm10qq12017.htm
[14] http://www.reuters.com/article/us-whole-foods-stake-jana-partners-idUSKBN17C29T

David Papau, Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. They and their clients may own securities mentioned in this column. Their views do not necessarily reflect those of CIBC World Markets Inc. If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor.