

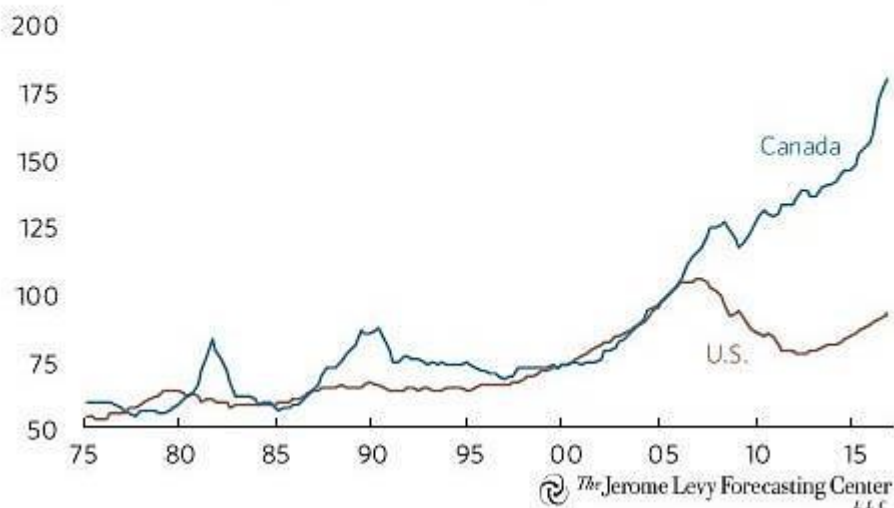
May 2017



Did The Music Just Stop?

Real House Prices Surging in Canada

Dallas Federal Reserve: Real House Prices
 seasonally adjusted, index, 2005 = 100, last data point Q4 2016



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Canada just experienced something that hasn't happened in 26 years – a run on a bank! In this case, Home Trust, via its parent, Home Capital Group Inc. was under Ontario Securities investigation for not disclosing the results of an internal investigation into whether 45 mortgage brokers had falsified employment and income information. Martin Reid, company president, was shown the door and founder and current chairman, Gerry Soloway, resigned. Amidst this uncertainty, investors pulled millions in cashable high interest savings deposits; by May 10th savings deposits totalled \$130 million, down from \$2 billion a month earlier. The problem is that these deposits have already been loaned out!

¹ The Jerome Levy Forecasting Center. May 9, 2017.

Home Trust operates as Canada's largest alternative lender, meaning a sub-prime lender for borrowers who do not qualify at a major bank. The lender claims it is business as usual and has secured \$2 billion in financing from the Ontario Hospital Workers Pension Fund. Unfortunately, not only is the interest rate on the financing 10%, but Home Trust is required to pay an additional \$100 million commitment fee (with other charges) on the first billion, bringing the effective lending rate on this money to 22%. Now I'm not in the lending business, but borrowing at 22% and lending it out at 4.9% seems like a surefire way to lose money!

Home Capital shares reacted by losing 80% of their value in just two weeks, decreasing roughly 90% from their peak. Because they represent just over 1% of mortgages in Canada, many claim that any impact will be contained solely to Home Trust deposits. The problem is that there is already evidence of some contagion. The second largest alternative lender in Canada, Equitable Group, has admitted a decrease in deposits as well, and its shares fell 50% before rebounding slightly.

This comes as no surprise to Ben Rabidoux of North Cove Advisors, who has been pointing out for years that mortgage fraud is a systemic problem in Canada. Based on information gleaned from interviews with industry mortgage brokers, Ben's work shows that while Home Capital may have been the poster child for mortgage fraud, it is actually a far more pervasive, widespread issue.

While Home Capital's problem was a result of mortgage fraud and not bad loans, it appears that other lenders are doubling efforts to verify financial documents. This is important to note because the U.S. housing crisis taught us that it was the tightening of lending and credit that sunk real estate and the banks. Home Capital's problems may therefore be the warning sign that credit conditions are tightening in Canada.

When it rains, it pours!

On top of mortgage issues, the Canadian housing industry continues to face government attempts to lower prices. On April 20th, Ontario announced a 15% tax on foreign investors (effective immediately) as well as other measures such as rent controls. This tax would be applicable throughout the Greater Golden Horseshoe region of Southern Ontario, representing 9.5 million people and over 25% of the total Canadian population.

All bubbles need a thesis. In the case of housing, it didn't matter that home prices in Toronto were disproportionate to income or rents, since foreigners would continue to pay increasingly higher prices. Perhaps this thesis will now be thrown into question.

As in musical chairs, when the music stops and everyone rushes for a chair, some find themselves out of the game. Have Toronto real estate speculators just realized the music has stopped? Time will tell. As the chart shows, new listings recently surged to a 10 year high after hitting a 10 year low just two months prior.

New Listings: Greater Toronto



For now, it is clear that sub-prime is broken. Home Capital has already collapsed but I would suggest avoiding other sub-prime lenders such as Equitable Group, Laurentian Bank, or Canadian Western Bank who was listed as one of the creditors when, The Walton Group, one of Canada's biggest private real estate companies based out of Calgary went bankrupt last month.

The Toronto housing market is acting in line with what we've seen in bubble conditions in other industries in that the biggest move is the last one. In 1981, gold moved up from \$600 to \$850 in the last two weeks of its bubble. Between January and April of 2000, the NASDAQ measured an increase of 25% in tech stocks. Similarly, the Toronto housing market has moved up 33% in one year (6% in March alone!) while experiencing its lowest wage growth in recent history.

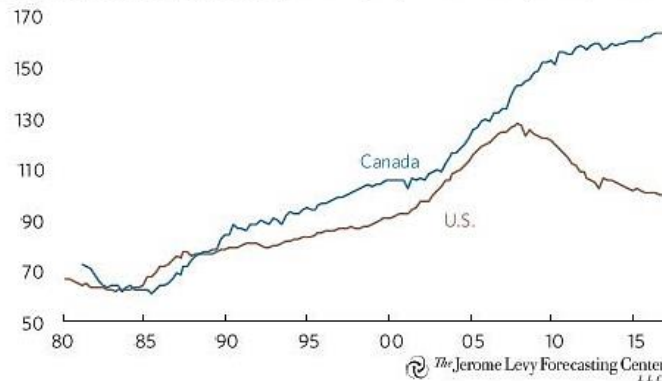
David Madani of Capital Economics pointed out the "ominous parallels with what happened in the U.S. a decade ago." Cracks in the U.S. sub-prime market appeared in June 2008 when, Countrywide Financial, the poster child of U.S. sub-prime lending was prosecuted for unethical lending practices. The similarities between Home Capital and Countrywide are shocking (ie. sub-prime lending, underwriting fraud, and a run on the bank, etc.). Countrywide was eventually sold for 10% of its trading price, only a few months earlier. Few in the U.S. predicted the cracks in sub-prime and collapse of Countrywide would lead to an entire U.S. credit and real estate collapse. Even big money centre banks like CitiBank and Bank of America lost roughly 90% at their 2009 bottom. Bond fund manager Bill Gross likened the collapse in sub-prime to Plankton in the ocean. If you kill the Plankton, "eventually the sharks will die." In other words, taking the "starter home" buyers out of the market eventually takes the big buyers out too.

² Ben Rabidoux, North Cove Advisors. May 18, 2017.

Time will only tell if problems in sub-prime and a tightening credit market in Canada will take out the sharks, like Rosedale in Toronto or the westside of Vancouver, but for now the bottom of the food chain has been significantly depleted!

Canadian Household Debt Well above U.S. Peak

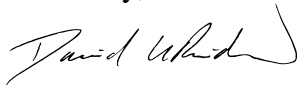
BEA, Federal Reserve, Statistics Canada, BIS: Household Debt as % of Disposable Personal Income*, seasonally adjusted, last data point Q4 2016



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Until we know how Home Capital's demise will reverberate through the Canadian economy, I would avoid all the big six banks in Canada. The next several months could prove very interesting. Stay tuned!

Sincerely,



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³ The Jerome Levy Forecasting Centre. May 9, 2017.