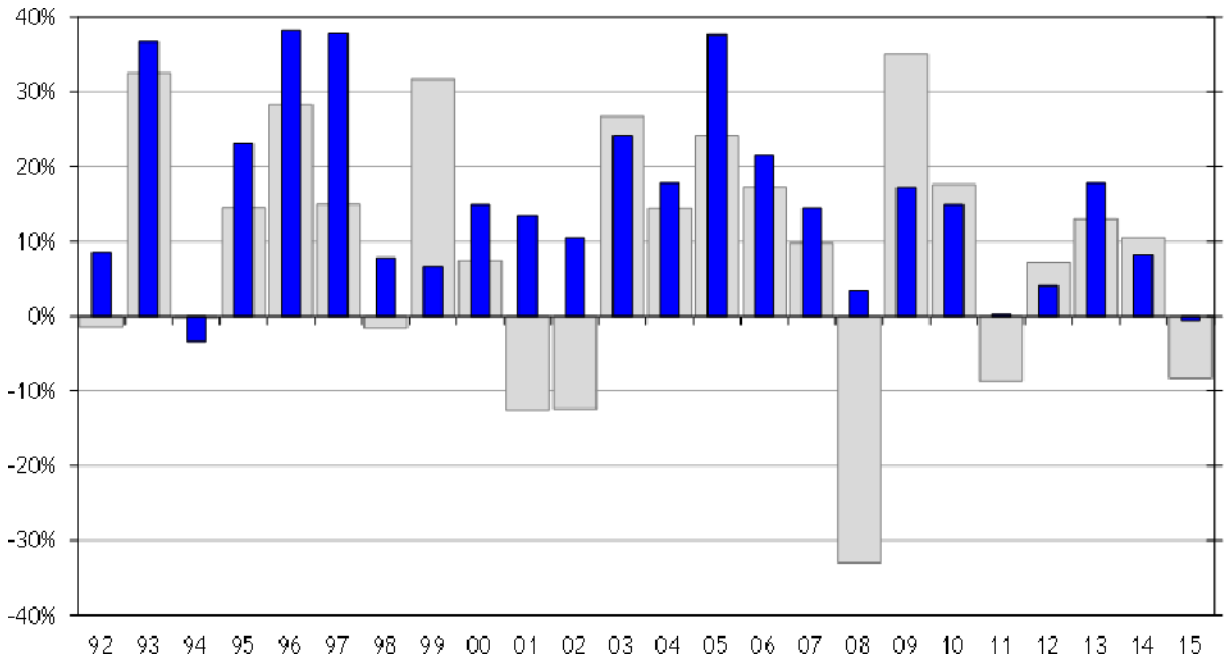
December 19th, 2016

"Won2One" with Nick Foglietta

Tactical Equity Income Model Portfolio Record



Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: 100% stocks
S&P/TSX 60 Closing Value: 15,251
TSX 200 Day Moving Ave: 14,329
% Above/Below 200 Day Moving Ave: **7.3% Above**
Levels for change: 50% stocks - **TSX 15,045** and 100% cash at – **TSX 13,612**

Weekly Quote

"I think we should build a great big firewall…and make the Russians pay for it."

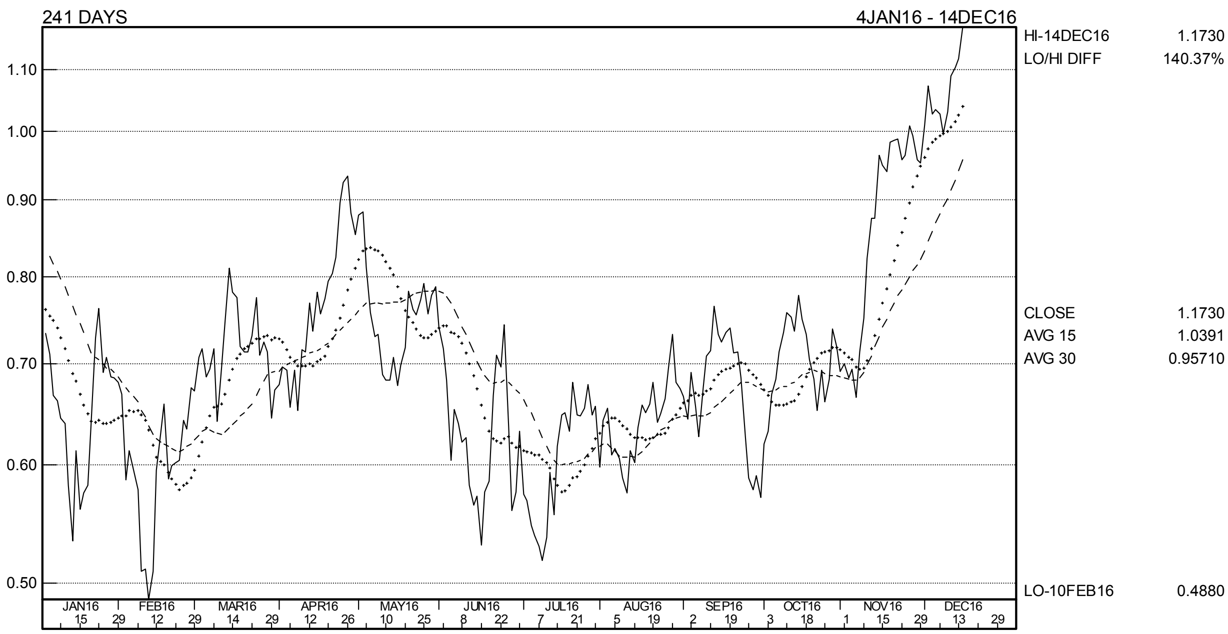
@Stockcats Tweet

Let's Talk Real Estate

As markets wind their way down into the Christmas holiday period, I thought it would be nice to take a step away from stocks and bonds and look at Canadian real estate markets.

Mortgage rates are moving higher. Last week we saw the TD bank raise interest rates up another 0.10% to 2.94% for a 5 year fixed rate. This is 0.30% above the low level set last summer of 2.64%. In reality, the Canadian banks are dragging their feet when it comes to moving mortgage rates higher. Take a look at the chart below for the 5 year Canadian Government bond.

CDA 5 YR BOND YIELD C5Y.ZZ.T



Since the US election, the yield on the 5 year Canada has gone up by over 0.50%...therefore mortgages are running behind the bond market increases. It makes sense why banks are slow to move on mortgage rates; they don't want to upset the "*real estate apple cart"* if at all possible!

Before we go any further on this topic, let's take a look at a few Canadian statistics.

- **The debt to disposable income ratio in Canada hit 168% in November**. That figure means Canadians ON AVERAGE owe $1.68 per dollar of disposable income. (The US housing bubble peaked in 2007 at 149% by comparison.)
- **Total household credit reached $2.004 trillion**, with $1.31 trillion in mortgages and $590 billion in credit cards, car loans and personal loans. (Not sure where the difference comes in between those two numbers and the total.)

- **Debt growth continues to grow nearly twice as fast as income growth in Canada**.
- **Total value of financial assets and real estate in Canada rose to $10.13 trillion**.

It is important to see what these numbers are telling us as Canadians. When we understand what the numbers say, we can apply them towards making some future assumptions more accurately.

First and foremost…Canada is chocked full of debt! An article in last week's Globe and Mail included a quote from Douglas Porter from BMO who has been around for a long time! Doug stated:

"Rock-bottom interest rates combined with soaring real estate prices have been responsible for the high pace of borrowing and the spike in mortgage debt. These two inputs have been, far and away, the primary driver (to where we stand today)."

Secondly, debt has not mattered up to this present moment.

To that point, many economists have argued "what is so bad about $2 trillion in debt if there are $10 trillion in assets backing it?

The correct answer: **DISTIBUTION of the debt and the assets**. **The wealthy own a massively disproportionate amount of that $10 trillion amount of assets**. They are also not overly leveraged where higher interest rates will impact them in the shorter term. The middle class and the younger generations have much nastier balance sheets for their households. **And these are the reasons why the debt picture could get ugly…quickly under certain conditions**.

To see where the debt and higher interest rates are likely to matter we need to go to a typical residential neighbourhood….

Let's take a typical street in "Anywhere, Canada". On Anywhere street there are 20 houses. Ten of those homes are clear title with no debt attached. The people in those homes really don't care what the price of their house is as long as they don't intend to move in the near future. The next 7 homes have manageable debt attached to their homes. Again, these 7 really don't care about their debt or the price of their home as long as they intend to stay put for the foreseeable future. **But 3 of the 20 are way over their head in debt!** These three intended to stay in their homes but rising interest rates have made their homes unaffordable to their family budgets…they MUST sell.

In reality, all 20 of those homes on Anywhere Street will see their PRICES predicated upon the selling prices of the 3 homes that must be sold. When interest rates go up too quickly, this process happens relatively quickly. **And here is the unfortunate reality, once price gains in real estate stop…usually more than just the 3 "upside down"**

mortgage homes want to sell…and that is when prices decline because the "speculative buyers" that created the extra "demand" necessary to keep housing propelling higher evaporate with the lower prices.

Conclusion: It does not matter how "conservative" you have been with your debt and finances…if the housing prices start to decline any significant amount, the most indebted homes in your neighbourhood will dictate the selling price for all homes on the street!

All one has to do is look back at what happened in the US in 2007/2008 to see a real life example of this process. Will it happen? Who knows? **All I can say with certainty is that if interest rates keep heading higher…real estate will be negatively impacted**.

Here is a great question to ask yourself at present time: **Do you really care if the price of your home goes down in the next 5 years?** The answer to that question is really quite simple if you own your home free and clear or with a manageable amount of debt.

The answer is No…not really.

If the price declines on your home and you aren't planning to sell…who cares? If you are needing to move, then it is most likely that you will find the price of the home you want to purchase has declined too so it won't make a massive difference.

The world is far too comfortable with low interest rates and the asset prices that accompany those low rates. Be sure to look at your own situation and make good decisions while interest rates are still low…you just never know when that might change.

How Much Could Interest Rates Go Up?

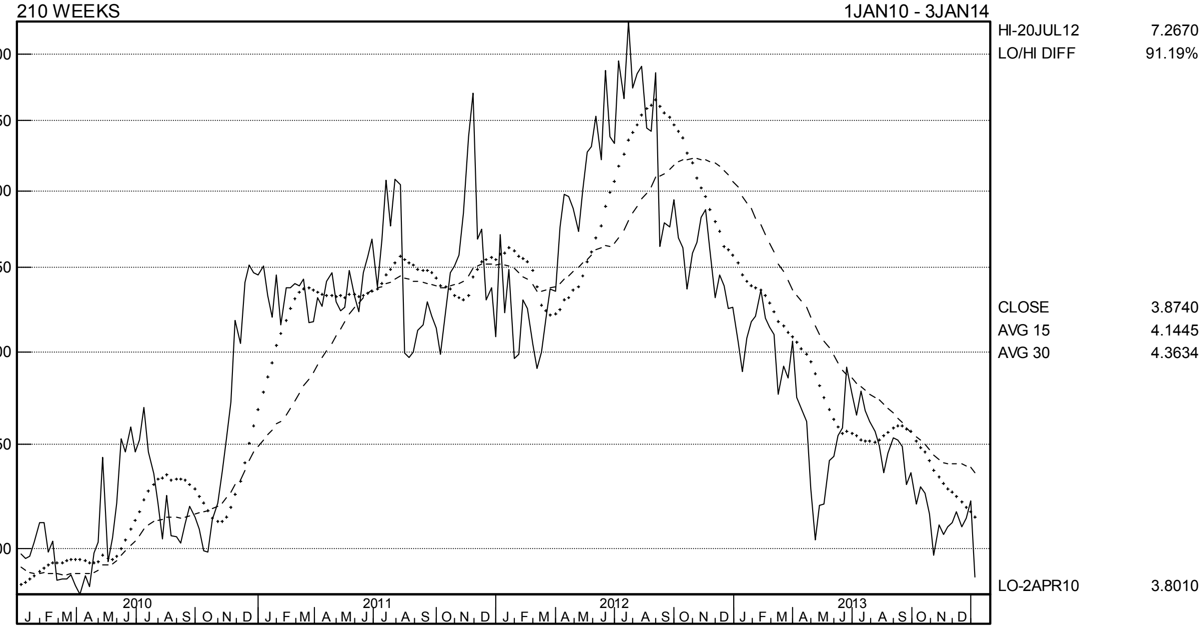
Nobody can predict the answer to that question with any certainty.

How I frame the question of the how much interest rates could go up is in reference to how much of a loss of faith could investors have in the global central banks?

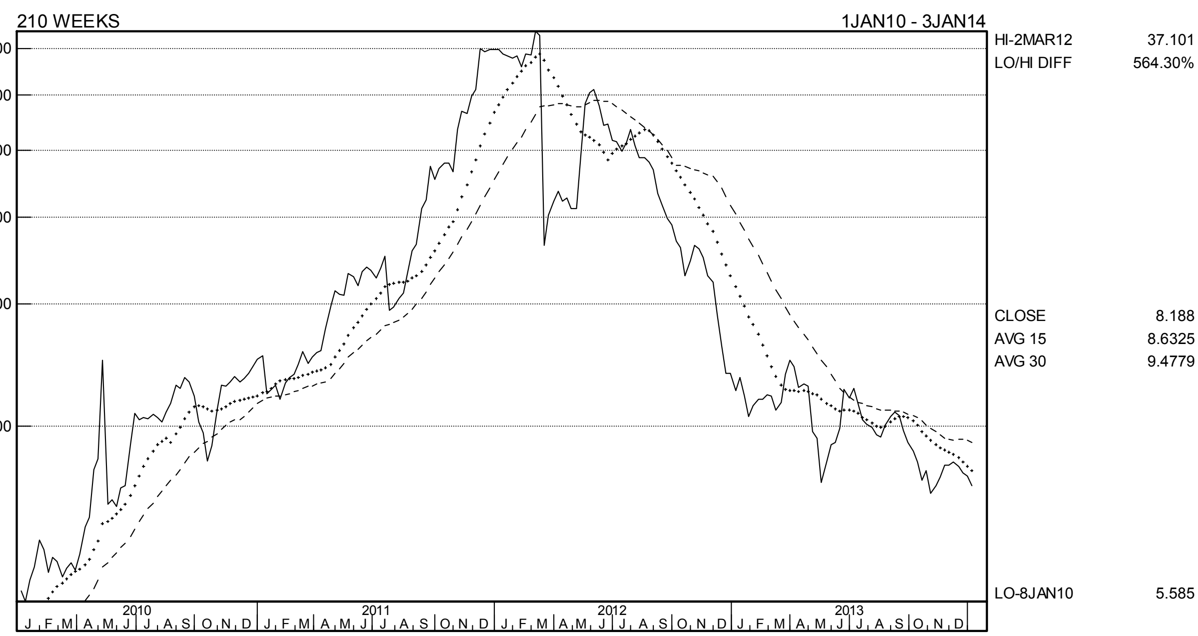
The two examples below are not really great because the situations surrounding these two countries were totally different than I imagine a Canadian interest rate spike would encounter. But the two charts show how quickly interest rates can change when the perception of investors change:

The first chart is the Spanish 10 year bond yield from 2010 to 2013. The second chart is of the Greek 10 year bond. Here we remember how the "PIGS" (Portugal, Italy, Greece, and Spain) were perceived to be getting ready to be shown the door out of the Eurozone.

SPAIN GOV'T LONG SPA10Y.ZZ.I

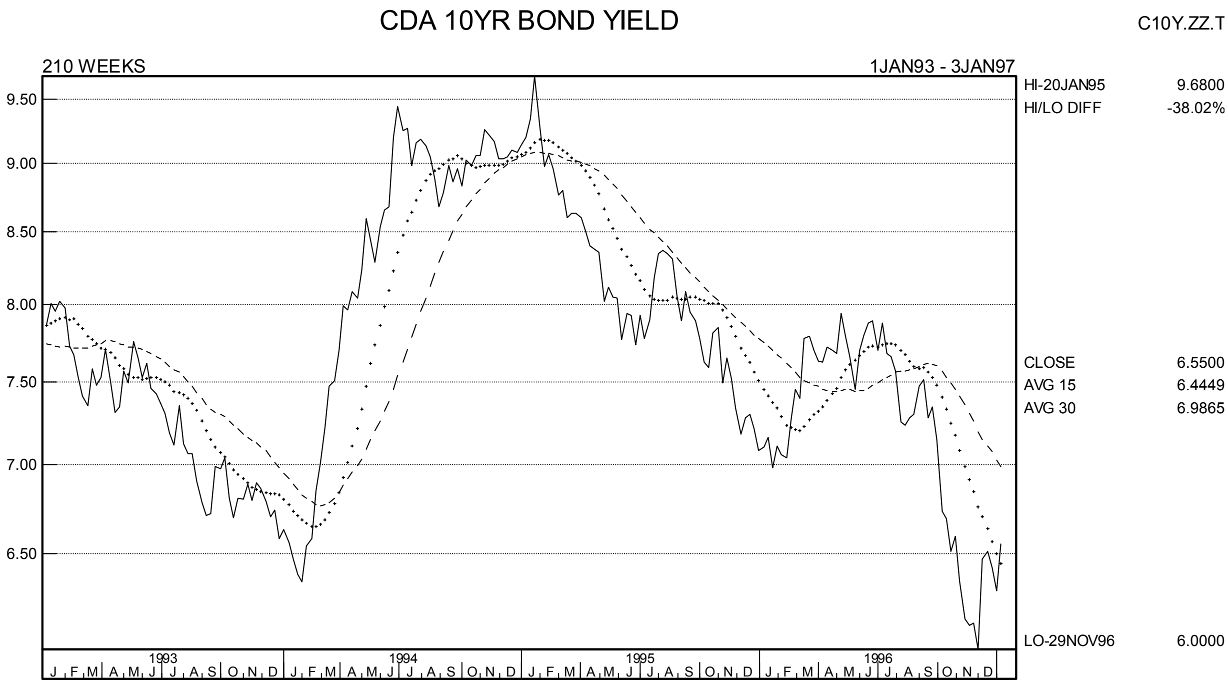


GREEK-GOVT BOND 10Y YIELD GRE10Y.ZZ.I



Again, not a totally fair comparison but the point is made clear…interest rates can move quickly when financial conditions change.

Let’s use an example a little closer to home. The chart below is of the Canadian 10 year bond yield from 1993 to 1996. Why interest rates took off to the upside in 1993 was for the very same reasons we are discussing today…rising inflation fears.



Hey, that was a pretty fast rip to the upside!

It has been a long time since we have seen anything remotely resembling rising interest rates. We will see where this goes but don't assume it can't happen here…again!

Wealth Management in Nanaimo, B.C., Canada. He has been managing money since 1988.