RBC Wealth Management
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INVESTMENT & WEALTH MANAGEMENT
Today and for the Next Generation

With Nick Foglietta **May 18, 2017**

The Great Narrowing: Market Exhaustion

Moody's Downgrade of Canadian Banks – in a nutshell, "high debt levels and soaring house prices could lead to a more challenging operating environment for banks in Canada for the remainder of 2017 and beyond." – Moody's

Let's dissect this idea a little bit on the following pages.

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"We're the fricking Guardians of the Galaxy!"

-Rocket Raccoon

SOUNDS LIKE SOMETHING JANET YELLEN WOULD SAY

Tactical Equity Income Model Portfolio Record

Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: 50% stocks 50% cash
S&P/TSX 60 Closing Value: 15,610
TSX 200 Day Moving Ave: 15,147

% Above/Below 200 Day Moving Average: **3.05% Above**

Levels for change: to 100% stocks - **TSX 15,904** and 100% cash at **14,390**

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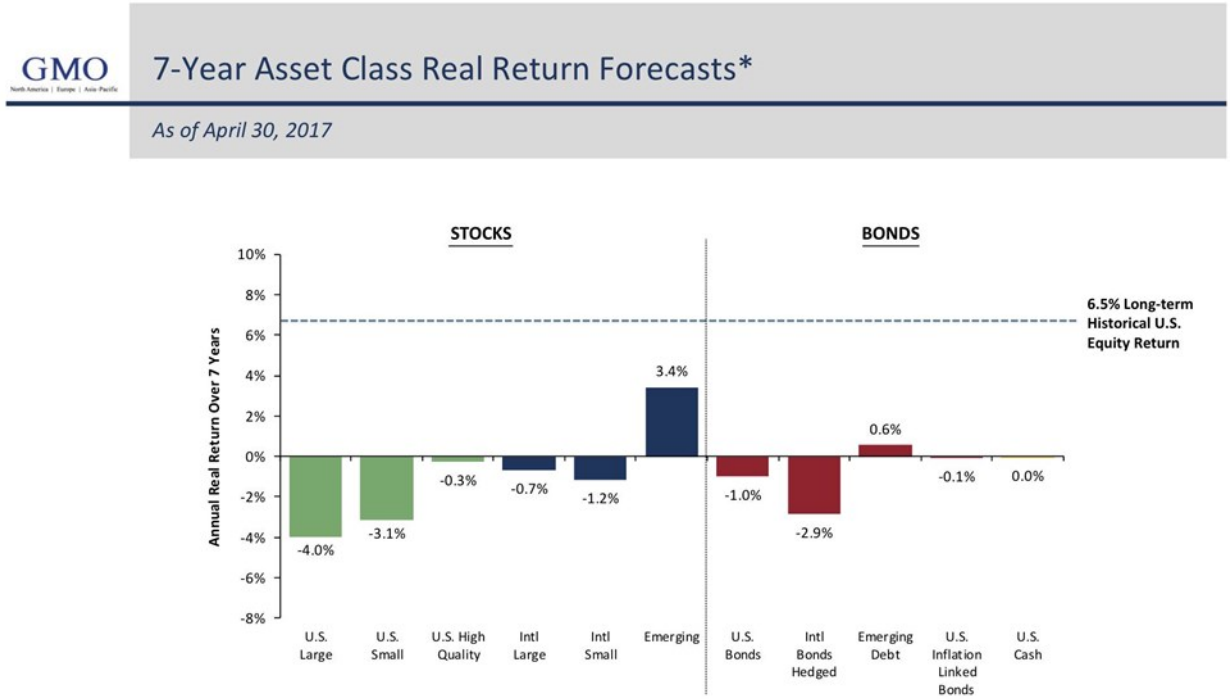

The Narrowing

What is challenging about the Canadian financial landscape at present when it comes to a bank's business model? The yield curve is "steep", real estate prices are high so distressed homeowners are able to sell at a profit rather than be foreclosed upon, investors are pouring money into stock based investments that earn the banks fee revenue since interest rates on fixed income investments are so low…It doesn't get any better for a bank than it is right now in Canada!

So why a warning by Moody's now?

My first thought is that, historically, Moody's has been very late to start cutting investment ratings and have ended up looking like "arsonists hanging around the burning buildings" by the time they actually made ratings changes. The second thing that came to my mind, it makes no difference if the economy keeps improving or if Canada begins to lurch towards a recession, the real estate bubble is peaking under both scenarios. (Higher interest rates will come if the economy keeps improving, or the debt bubble will burst if we have a recession…neither is great for the real estate markets.)

Whatever the motivation for the change, I am taking the action as another sign of "market exhaustion" and encouragement to stay focused on being conservative. When the next real estate downturn comes I believe that Canada, Australia, and New Zealand will be the epicenters of the mortgage challenges. We will see.

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U.S. Stock Market Performance – From the Canadian investor's perspective, US stocks have continued to perform nicely. As I have stated before, a large amount of the performance has simply been the decline in the Canadian dollar when compared to the US dollar.

But even the US stock market itself has become a bifurcated example juxtaposing a small number of growing companies back dropped against a large number of flat/falling stocks. The charts below drives that point home with style!

Chart 1 shows how Facebook, Apple, Amazon, Netflix and Google (Alphabet) have increased in value by $260 billion since March 1st and the other 495 stocks in the S&P 500 have lost approximately the same value!

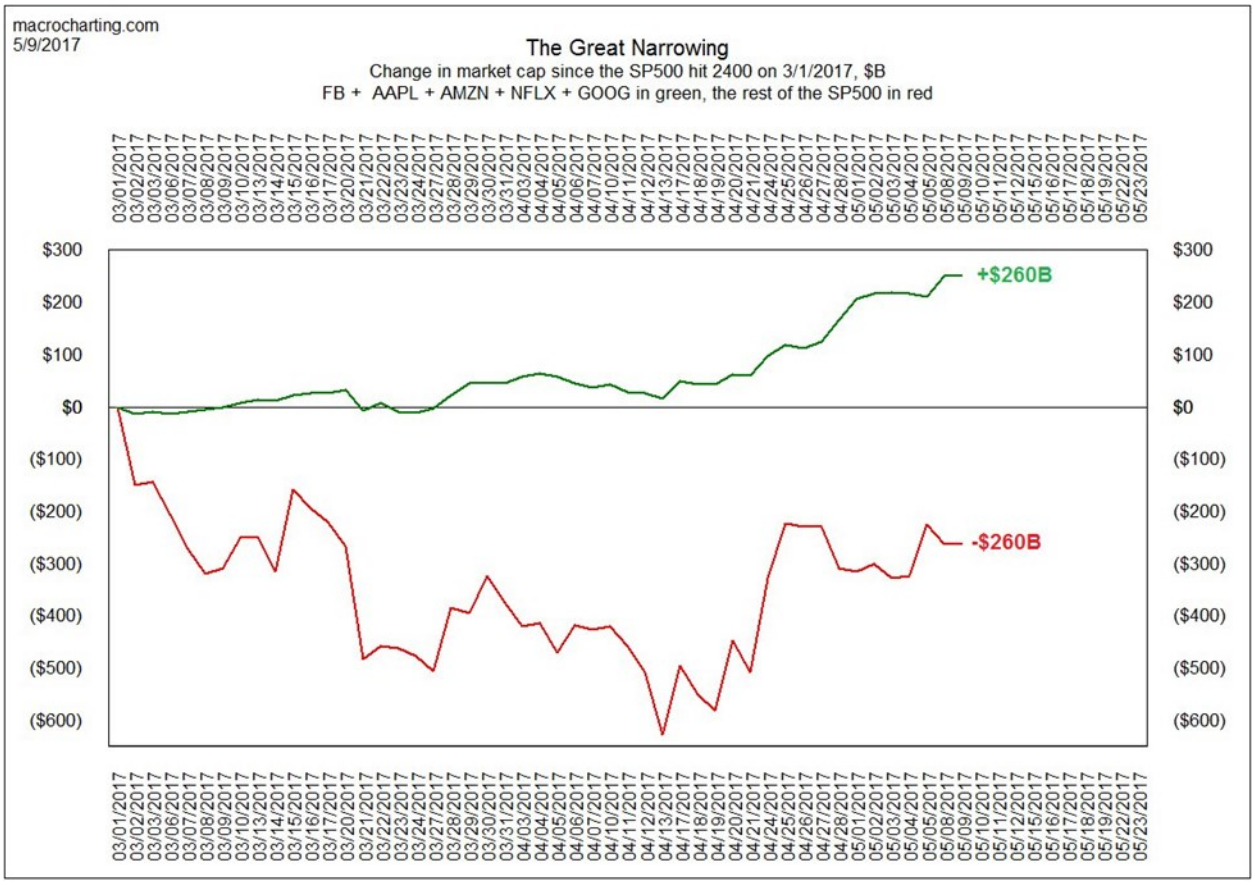

Chart 2 on the following page drives home the same point over a longer period of time. It compares a "market capitalized" view of the S&P 500 vs. an "equal weighted" view.

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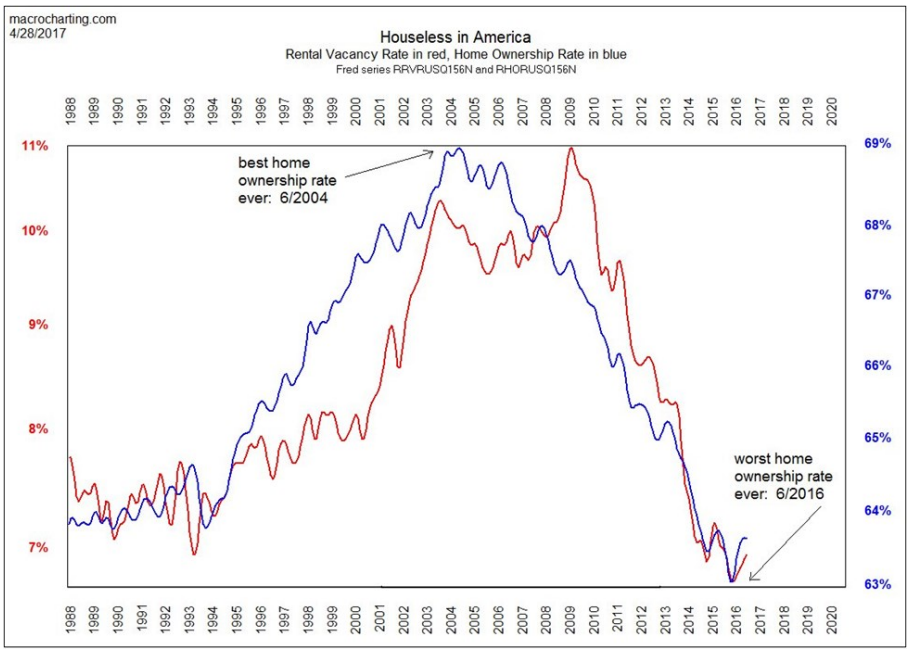
The timeframes of the charts above are short, but it does remind me a phenomenon I have seen at “exhaustion moments” in the past. Only a few large capitalized companies carry the stock markets higher in the exhaustion phase of the cycle.

Is Canada is Heading into a Housing Recession?

An editorial caught my eye that was looking at the aftermath of the US housing recession in 2008. What happened to all the people who ran into financial trouble when they could not afford to keep their homes anymore?



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The chart on the previous page is fascinating. You need to think about it for a while, but you will see just how devastating a true housing recession is!

The blue line on the chart shows the home ownership rate as a percentage of population across the entire US. Notice it peaked in 2005. When the home ownership peaked, not surprisingly, there was the largest number of vacancies available in the US rental market at the same time. When the bubble burst and people started losing their homes the vacancy rate plummeted at the same time! The people who lost their homes had to live somewhere….

But here is the key to remember.

People tend to defend their home with most of their savings before they have to turn in their keys to the mortgage lender. **Therefore, when the eventual recovery begins they no longer own assets that benefit from the recovery.**

Realize that these types of concerns are premature. Yes, the mortgage market in Canada is suffering, but it might get bailed out by the Feds and the problem may simply evaporate for the present time. But the reality check for me is there are more “cockroaches” showing up around Canada’s frothy real estate markets. This is a good time to do a personal review and make sure your exposure is reasonable and on a solid foundation.

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