Weekly Updates Issue # 659

1. Weekly Markets Changes
2. Latest inflation data will give BoC ‘headaches’ next week
3. Canadian home sales dip, as year-over-year prices also cool
4. Real asset outlook as U.S. rates rise
5. What to look for if you have to renew your mortgage
6. Housing starts fell in March: CMHC
7. Trailing fees paid to TD brokers result in proposed class action

1. Weekly Markets Changes

[April 13, 2018]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
15,273.97 +66.56 +0.44%	2,656.30 +51.83 +1.99%	24,360.14 +427.4 +1.79%	7,063.45 +43.20 +0.61%	$0.7938 +1.03c +1.31%	$1,346.20 +13.17 +0.99%	$67.39 +5.33 +8.59%

2. Latest inflation data will give BoC ‘headaches’ next week

[April 13, 2018] While March’s consumer price index will get a lot of attention next Friday, the Bank of Canada is likely to steal the limelight with its April 18 announcement and Monetary Policy Report (MPR).

In a week-ahead report, National Bank says, “The unexpected strength of inflation in Q1 may cause some headaches at the Bank of Canada […]. While the central bank had estimated Q1 CPI to grow only 1.7% y/y, inflation is in fact heading for a 2.1% print.”

National Bank predicts the central bank will stay on the sidelines, perhaps pointing to “the latest Business Outlook Survey, which showed a below-average ratio of firms reporting that labour shortages were restricting their ability to meet demand.”

The BoC is expected to comment not only on NAFTA but also, in its MPR, “on the potential upward risk to its growth forecast on account of the fiscal stimuli announced in provincial budgets,” the report adds.

Retail sales in February, also due out next Friday, are “likely expanded for a second month in a row,” says National Bank.

CIBC discusses similar points in its week-ahead report, noting that, with rising oil prices, “Canadian inflation is set to reach its fastest pace in more than six years.” It expects manufacturing and retail sales will be “positive, but not the barnburners that may be anticipated following a lacklustre few months.”

CIBC is not expecting the BoC to raise rates next week. Despite the strong sentiment reported in the Business Outlook Survey, it points to January's GDP decline, Q1 job losses, pipeline controversy and a housing market "going through its biggest test since 2008" as reasons to put off a rate hike.
That said, "another upside surprise on inflation come Friday would see those expectations ratcheted up again," the report says.

U.S. and global news to watch

In the U.S., look for March industrial production, housing and retail sales data. Globally, Japan will release trade balance and CPI news, and China will have Q1 GDP numbers.

3. Canadian home sales dip, as year-over-year prices also cool

[April 13, 2018] Canada's real estate industry organization says the number of homes sold in March plunged 22.7% and the national average price was down 10.4% from the same month last year.
The Canadian Real Estate Association says the sales activity marked a four-year low for the month of March and was 7% below the 10-year average.
The national average price for all types of residential property was about $491,000, which was down 10.4% from March of last year—with the Vancouver and Toronto markets causing most of the drag.
Excluding Canada's two most expensive real estate markets, the national average price would be $383,000—a decline of 2% from March 2017.
March had the third consecutive double-digit decline compared with the comparable months last year, when prices in the Greater Toronto Area soared to record highs.
CREA says activity was below year-ago levels in more than 80% of all local markets, in all major urban centres except for Montreal and Ottawa, with the vast majority of year-over-year declines well into double digits.

More housing data

According to a Friday release from Royal LePage, home prices in Canada experienced slowing year-over-year increases in the first three months of 2018.
"On a quarter-over-quarter basis for the same period, home prices in many markets across the country remained relatively flat, with approximately half of the markets studied by Royal LePage posting slight declines," the release says, citing the results of the company's house price survey.
Out of the 63 real estate markets measured, Royal LePage found "declines were most prevalent in the Greater Toronto Area, and to a lesser degree in the

Greater Vancouver detached home segment." Dips in demand that are weighing on home prices, it says, are due to both "eroding housing affordability" and government measures tied to mortgage financing.

Still, "a return to normal [housing] activity levels is anticipated in the second half of the year" in both markets, it adds.

4. Real asset outlook as U.S. rates rise

[April 12, 2018] The prospect of rising interest rates in the U.S., both for the short- and long-term, is a growing concern for real asset investors.

So says Larry Antonatos, managing director and portfolio manager with the Public Securities Group at Brookfield Asset Management in Chicago. During a late March interview, he spoke about the historical impact of tightening cycles and the potential future impact of today's rate-hike cycle on real asset investments.

On March 21, the U.S. Federal Reserve raised the target range for its key rate by a quarter-point. The range went from 1.25% to 1.5%, to 1.5% to 1.75%—the central bank's sixth increase since 2015. That was followed by new Fed Chair Jerome Powell stating in his first speech, on April 6, that he's committed to gradual rate hikes.

Meanwhile, U.S. inflation data in February suggests inflation pressures remain muted—for now. The consumer price index inched up 0.2% for that month, after jumping 0.5% in January, the Labor Department said on March 13.

Antonatos, whose firm manages the Renaissance Real Assets Private Pool, offered his assessment of how short-term and long-term interest rates are affecting the real asset space.

Real asset debt beating real asset equities

Throughout the Fed's current tightening cycle, which began in November 2015 with a starting rate of 0.25%, real asset equities in the U.S. have not performed as well as in previous rate-hike cycles.

As of late March, "Infrastructure equity and real estate equity had delivered 0.8 times and 0.6 times, respectively, the return of global equity," says Antonatos. But real asset debt was doing better, given it was "delivering roughly two times the return of global bonds."

"We have a few more years to go […] so it remains to be seen what will happen over the whole cycle," he says. "Market expectations are for an ending rate of 3% at the end of 2020," and that "implies a total of 270 basis points of tightening over 61 months."

The Fed's previous tightening cycle began in May 2004 at 1% and ended in August 2007 at 5.25%—that represented a total of 425 basis points over 39 months, says Antonatos, so it was much more aggressive.
"Over that cycle, infrastructure equity and real estate equity delivered roughly two times the return of global equity, and real asset debt delivered roughly 1.5 times the return of global bonds," he adds.

What about long-term rates?

The impact of long-term interest rates, which are driven by the market and not U.S. federal policy, can be measured by looking at the historical performance of real assets using standard statistical models, says Antonatos.
Based on his firm's analysis, "We have assumed a 100-basis-point shock to the U.S. 10-year Treasury yield," he says. They predict infrastructure will have a flat performance over that time.
Real estate equity will underperform versus global equity, he adds, with the former bringing in -2% and the latter 5%. Antonatos says broader equities will primarily benefit from "strength in the financial sector."
On the upside, real asset debt will likely offer performance of roughly -4.5%, "which is significantly better than the expected performance of global bonds, [at] -7%."
Despite the pressure of rate hikes, Antonatos says the long-term opportunities of real assets remain, including "income from dividends on equity and coupons on debt, capital appreciation from long-term appreciation of underlying real assets, and inflation protection—from the inflation-linked pricing on underlying real assets such as regulated assets."

5. What to look for if you have to renew your mortgage

[April 11, 2018] New rules introduced this year stipulate that homeowners looking to renew their uninsured mortgages are subject to a new stress test unless they stick with their existing providers—impeding their ability to seek out more competitive rates.
Nearly half of all existing mortgages in Canada will need to be renewed in this year, substantially more than in prior years, according to a new report, amid rising interest rates and the new rules.
A CIBC Capital Markets report says an estimated 47% of all existing mortgages will need to be refinanced this year, up from the 25% to 35% range in a typical year.
The increase is an unintended consequence of various rounds of regulatory changes aimed at reducing risk coupled with rising house prices that made it

harder for homebuyers to qualify, says CIBC's executive director and head of North American Rates Strategy.

Ian Pollick says borrowers in recent years have taken on mortgages with two- or three-year durations, which are now up for renewal alongside the typical five-year mortgages.

The increase in renewals comes as mortgage rates have been rising, with five-year fixed rates up about half a percentage point compared with a year ago.

Market effects

Certain markets exhibit seasonal distortion as residential housing activity typically picks up this time of year.

"As a result of how Canadian housing finance works, there is a resultant seasonal distortion in the interest rate market across both cash and swaps," explains Pollick in a separate and earlier report.

Specifically, as financial institutions hedge their commitment and renewal risks, they're forced into the market to hedge their interest rate exposure, he says.

Given the potential for these flows to be large and concentrated, in prior years there has been a notable influence on the five-year sector of the cash and swaps curve, typically resulting in wider five-year swap spreads, as the bulk of fixed-rate mortgages are five years in length.

This year's distortion will be different from previous years.

The large amount of renewals, as opposed to originations, suggests a later start to market seasonality. Further, this is the first legitimate tightening cycle that intersects with mortgage season, says Pollick. So there's risk that higher rates may restrict households from extending the duration of their new mortgage commitments.

"That would suggest the 'person of interest' may not be five-year spreads," he says.

His call: "We like being paid late-dated three-year or four-year matched-maturity swaps (MMS) to take advantage both of the expected seasonality in addition to the uncertainty of which tenor mortgage flows might bias."

6. Housing starts fell in March: CMHC

[April 10, 2018] The annual pace of housing starts slowed in March compared with February said the Canada Mortgage and Housing Corp. on Tuesday.

The seasonally adjusted annual rate slowed to 225,213 units last month compared with 231,026 in February.

Multiple urban starts, which includes buildings such as apartments, townhouses and condominiums, fell 7.3% to 144,578 units in March.

Single-detached urban starts increased 9.5% to 63,659.
Meanwhile, rural starts were estimated at a seasonally adjusted annual rate of 16,976 units.
The six-month moving average of the monthly seasonally adjusted annual rates edged up to 226,842 units in March compared with 225,804 in February.
Royce Mendes, senior economist at CIBC Economics, said in a note to clients that higher interest rates and OSFI's mortgage stress test that came into force in January would likely "keep a lid on growth in the sector."
"We continue to expect that homebuilders will break ground at a slower rate over the remainder 2018," he said.

7. Trailing fees paid to TD brokers result in proposed class action

[April 9, 2018] Trailing commissions paid to brokers who sell mutual funds are under fire in a proposed class action against TD Asset Management (TDAM). Siskinds LLP in London, Ont. and Bates Barristers P.C. in Toronto have filed the class action, a release said on Monday.
The action alleges that TDAM, as trustee and manager of TD mutual funds, pays substantial sums of money out of TD mutual funds as trailing commissions to discount brokers, and that these commissions reduce investors' returns.
In the release, Siskinds says TDAM describes the purpose of the trailing commissions as compensation for "services and advice" provided to investors. However, discount brokers are prohibited from providing investment advice to investors, so investors who hold these funds in discount brokerages allegedly receive no value for the trailing commissions paid.
When asked for comment, a TDAM spokesperson said in an email that the company is unable to comment since the matter is before the courts.
The release says the action "seeks to advance claims on behalf of all persons, wherever they may reside or be domiciled, who hold or held, at any time prior to the conclusion of the trial of the common issues in the proposed class action, units of a TD mutual fund through a discount broker."
Gary Stenzler, the proposed representative plaintiff in the action, says in the release that he invested in mutual funds to save for retirement and his children's education. "I was troubled to learn that the trustee of the mutual funds I owned was taking a portion of my life's savings to pay my discount broker for advice and services which I did not receive," he says in the release.
Paul Bates of Bates Barristers says in the release that it's time for investors to challenge the practice of paying trailing commissions to discount brokers,

which he says is common throughout the mutual fund industry in Canada. “This practice continues today despite ongoing regulatory review of embedded commissions having regard to investor protection concerns,” he says.

The proposed class action comes as the industry awaits policy on embedded commissions. Last fall, John Mountain, OSC’s director of investment funds and structured products, said a proposal could be expected in early 2018.

Recent industry commentary on mutual fund fees

For registrants who offer advice, the MFDA released a compliance bulletin in January of this year reminding firms of their obligation to inform clients about cheaper series of mutual funds.

“There have been several settlement agreements between provincial securities regulators and registrants relating to firms not having sufficient controls to advise clients when they become eligible for a lower MER series of the same mutual fund,” says the MFDA in the bulletin. “We expect members and approved persons to understand the products they recommend, including understanding circumstances where clients may be eligible for a lower MER series of the same fund.”

The SRO explicitly states that that expectation applies to both proprietary and third-party funds, and will be part of exams.

“In our examinations, we will be assessing whether members have implemented appropriate policies and controls in respect of lower MER series funds,” says the MFDA.

Today, IIROC released its final guidance on order-execution-only (OEO) firms to clarify the products, tools and information these firms can provide investors. Specifically, the guidance clarifies what tools are considered advice, and therefore not to be used by OEO firms.

In an accompanying notice, IIROC says that funds with trailing commissions for ongoing investment advice pose a conflict of interest for OEO firms, since they’re not permitted to offer advice. Under IIROC rules (section 42.3 of Rule 42), dealer members must address conflicts of interest considering the best interests of the client.

In the notice, IIROC says that it expects OEO firms “will make available, whenever possible, funds that do not pay a trailing commission for ongoing advice”—often Series D.

When Series D isn’t available (because a fund family doesn’t offer that series) and an OEO firm makes available another series that pays a trailing commission, “we also expect the firm to address the conflict by rebating to the client the portion of the trailing commission for ongoing advice, or taking other similar steps,” says the notice.

IIROC further comments that “management of the conflicts of interest relating to trailing commissions by OEO firms allows investors continued access to the widest possible range of investments.”

Have a nice and fruitful week!

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