

## Weekly Updates Issue # 696

1. Weekly Markets Changes
2. Why Wall Street turned its back on junk bonds
3. The \$4.5 trillion force that's helping to fuel market swings
4. Why the Dow has spiked 2,000 points since Christmas Eve
5. What the latest insolvency statistics reveal
6. Luxury home sales fall in 2018
7. BoC holds interest rate, views oil slump as temporary soft patch
8. Small biz owners get runaround from Service Canada: study

### 1. Weekly Markets Changes

[January 11, 2019]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
14,939.18	2,596.26	23,995.95	6,738.86	\$0.7542	\$1,290.25	\$51.59
+512.56 +3.55%	+64.32 +2.54%	+562.8 +2.40%	+232.6 +3.45%	+0.85c +1.14%	+4.20 +0.33%	+3.63 +7.57%

### 2. Why Wall Street turned its back on junk bonds

[January 11, 2019] The junk bond market, one of the biggest beneficiaries of easy money, has screeched to a halt.

No US high yield bonds were offered between November 30 and January 10, according to Dealogic. December marked the first month since the 2008 crisis without any junk bonds being issued, the research firm said.

The reversal of fortunes underscores how quickly sentiment can change in financial markets, especially in the riskiest pockets of Wall Street.

Deep fears about the end of the economic cycle similarly led to an exodus out of momentum stocks and the oil patch. Both the Nasdaq and crude oil tumbled into bear markets.

"The stock market and oil really drive the junk bond market. They were a double-barreled depressant in December," said Mark Howard, senior multi asset specialist at BNP Paribas.

The energy sector accounts for about 15% of the US high-yield market, making the junk bond market particularly sensitive to sharp swings in oil prices. The 2014-2016 oil crash sparked dozens of oil bankruptcies.

The silence of the junk bond market marks a sharp slowdown from last December, when 36 companies tapped the junk bond market to raise nearly \$18 billion, according to Dealogic.

'Starting to crack open'

The good news is that financial markets and oil prices have been on the upswing since Christmas Eve. People are less worried, for now at least, about a recession and the US-China trade war. That could allow for a reopening of the junk bond market.

A subsidiary of Targa Resources, an oil and natural gas pipeline company, successfully priced a high-yield offering on Thursday. In another positive sign, Targa was able to raise \$1.5 billion, twice as much as the Houston-based company originally sought. Sanjay Lad, director of investor relations at Targa, told CNN Business the deal was upsized because of "very strong investor demand."

It marks the first US junk bond issuance since late November.

"It's starting to crack open," said Howard.

This year, US high yield bond funds posted their best start in a decade, according to UBS.

Still, the boom-to-bust in junk bonds serves as another reminder of the role of easy money on financial markets.

Unbelievably low interest rates from global central banks forced investors to scour for returns elsewhere. Vast sums of money were poured into high-yield debt, allowing even some companies with shoddy balance sheets to borrow at reasonable rates.

But that easy money has begun to slowly fade away, with the Federal Reserve simultaneously raising interest rates and trimming its towering balance sheet. At the same time, Wall Street is on high alert for signs of a recession. A downturn would cause trouble for some companies that reside in the junk bond market.

Not surprisingly, investors backed away from that risky market late last year. Money has flown out of high-yield bond funds in 12 of the past 13 weeks, according to Bank of America Merrill Lynch.

"There is concern that the earnings cycle has peaked. The trade war is not a great help," said Mike Ning, chief investment officer at PhaseCapital, a boutique investment manager.

### **Prolonged shutdown could spark trouble**

Nervous investors have similarly retreated from another risky corner of the debt market: leveraged loans. These distressed loans had been a favorite investment for years but concerns about higher borrowing costs and slowing growth have changed the risk-reward calculus.

Private-equity giant KKR on Wednesday revealed that it has slashed its overweight exposure to leveraged loans to "zero."

"Given the dislocations of late, we want a little more flexibility," Henry McVey, KKR's head of global macro & asset allocation, wrote in a report titled "The Game Has Changed."

The fear is when the economic cycle ends, these highly leveraged companies will have trouble refinancing their debt. That could lead to a wave of bankruptcies.

"The market was sharply constrained in the fourth quarter. If we saw a prolonged period, you would have companies that would start to have challenges," said Howard.

### **Record-high corporate debt**

Consider that US nonfinancial companies rated by Moody's were sitting on \$5.7 trillion of debt as of the end of June 2018.

The ratio of nonfinancial corporate debt to GDP has never been higher going back to records that began in 1947, according to the Office of Financial Research, a Treasury Department bureau created after the 2008 financial crisis.

Even if a recession strikes soon, most companies aren't facing imminent deadlines to pay back debt.

Many CFOs took advantage of easy money to lock in low rates for extended periods. And record-high corporate profits, boosted by the corporate tax rate, have given companies lots of ammo to repay debt.

Most companies have "low refinancing risk" in 2019, according to a Moody's Investors Service report published on Thursday.

"When the markets get bumpy, high-yield borrowers can sit on their hands and wait," Howard said.

That's good because December showed they could be waiting a while.

## **3. The \$4.5 trillion force that's helping to fuel market swings**

**[January 10, 2019]** The Federal Reserve's rate hikes steal all the headlines. But behind the scenes, the Fed is conducting a \$4.5 trillion experiment. And it's unsettling global financial markets.

To revive the economy and the market, the Fed in 2008 took the unprecedented step of gobbling up vast amounts of government bonds and mortgage securities. The program, known as quantitative easing, was aimed at lowering long-term borrowing costs. Foreign central banks joined in as well.

Although economists debate the impact on the real economy, QE acted like a turbo booster for the stock market.

In October 2017, the Fed decided the economy was finally healthy enough to start shrinking its \$4.5 trillion balance sheet. So-called quantitative tightening accelerated to \$50 billion a month in the fourth quarter of 2018 — precisely when market volatility spiked.

Many market watchers believe that the balance sheet shrinkage — it's down \$500 billion from the peak — has at a minimum contributed to turbulence in financial markets.

"Once the Fed started quantitative tightening, the global stock market tipped over right on schedule," legendary investor Jeff Gundlach said on Tuesday during a webcast.

"There is an eerie correlation," said Gundlach, the founder of investment firm DoubleLine Capital.

### **Even Trump tweeted about QT**

Global central banks, including the Fed, collectively purchased \$9.1 trillion of assets between 2010 and 2017, according to Bank of America Merrill Lynch. That phenomenon encouraged investors to plow money into credit funds, lowering borrowing costs and juicing stock prices.

But that powerful trend reversed in 2018, with global central bank balance sheets shrinking for the first time since the crisis, Bank of America said. Not surprisingly, it was the US stock market's worst year in a decade.

And it's no coincidence that the junk bond market has shut down. December marked the first month without a US high-yield bond being issued since November 2008, according to Dealogic.

"We strongly believe liquidity & credit [are the] 'glue' for bull market," Michael Hartnett, Bank of America's chief investment strategist, wrote to clients in a late December report.

Even President Donald Trump has vented about QT. "Don't let the market become any more illiquid than it already is," Trump tweeted to the Fed on December 18. "Stop with the 50 B's. Feel the market, don't just go by meaningless numbers."

### **Fed tops list of fears**

The recent market mayhem wasn't principally driven by the Fed's shrinking balance sheet.

The wave of selling on Wall Street was set off by fears of a recession, concerns about the US-China trade war and worries the Fed was raising rates more quickly than the economy could handle. Improvement on all three fronts have since unleashed a huge comeback in the stock market.

"If you rounded up all the obvious suspects to explain the selloff, I'd say the No. 1 suspect would be the Fed," said Ed Yardeni, president of investment advisory Yardeni Research.

In hindsight, Yardeni said that the Fed added to investor angst by trying to simultaneously raise rates while significantly shrinking the balance sheet.

"Doing both backfired on them — and forced them to pause on raising rates," he said.

Of course, some think the focus on the balance sheet is misplaced — especially because the real economy looked solid in recent months.

"We got spoiled with no volatility and the market going up. Now we're seeking answers," said Andres Garcia-Amaya, global market strategist at Zoe Financial, an independent wealth management firm.

### **Powell did a 'full capitulation'**

Still, Wall Street has clearly become much more sensitive to news about QE. Consider how markets became unhinged on December 19 during Fed chief Jerome Powell's press conference. In particular, investors got fixated on Powell's comment that the balance sheet runoff would continue on "autopilot." The Dow closed down 352 points that day, wiping out an early rally of as much as 382 points.

It became such a big issue that Powell later walked back his comments. On January 4, Powell pledged patience and flexibility. He even opened the door to tweaking the balance sheet strategy — if warranted.

"We don't believe that our issuance is an important part of the story of the market turbulence that began in the fourth quarter of last year," Powell said. "But, I'll say again, if we reached a different conclusion, we wouldn't hesitate to make a change."

Powell's soothing words, along with a blockbuster jobs report, helped carry the Dow 747 points higher that day.

"Jay Powell did a full capitulation," Gundlach said. "The markets have been throwing a party since then."

The Dow has spiked more than 2,100 points, or nearly 10%, since Christmas Eve.

### **Vicious circle**

Peter Boockvar, chief investment officer at Bleakley Advisory Group, said it's all part of a vicious circle between markets and the Fed after a decade of ultra-easy money.

"Fed tightens, markets have a hissy fit as any child does, financial conditions cramp up, the Fed then backs off," Boockvar wrote in a note on Wednesday. "Market then rallies, financial conditions ease and the Fed is back in the game."

Still, it's sensible policy for the Fed to try to shrink its holdings. Historically low rates and a huge balance sheet give the central bank limited ammo to fight the next recession, which investors increasingly fear is around the corner.

The market's sensitivity to the Fed's balance sheet is a fresh reminder that this is all a grand experiment. No one really knows how it will turn out.

## **4. Why the Dow has spiked 2,000 points since Christmas Eve**

**[January 9, 2019]** Investors have decided that maybe the world isn't coming to an end after all.

The Dow has spiked about 2,100 points, or 10%, since Christmas Eve. Oil prices are up twice as much. Even risky junk bonds have joined the party.

The across-the-board recovery continued Wednesday, and the Dow flirted with the 24,000 level. The S&P 500 is trying for its first four-day win streak since September.

Fears of an imminent recession have been replaced by hopes of a soft landing. Investor angst has been soothed by calming words from the Federal Reserve, a blockbuster December jobs report and hints of progress in resolving the US-China trade war.

"All of a sudden, sentiment has shifted," said David Joy, chief market strategist at Ameriprise Financial.

[Read More](#)

Mounting evidence of an economic slowdown sparked the stock market's worst December since the Great Depression. The Nasdaq plunged into a bear market. The S&P 500 nearly followed.

Investors were scared that a record \$84 billion was yanked out of global stock funds during the six weeks ending January 2, according to EPFR data. The exodus surpassed the previous six-week high that was reached during the 2008 financial crisis, according to UBS.

"Stocks went too far. The market was pricing in a recession — but the fundamentals didn't support that," said Joy.

### **Powell changes his tune**

The Fed played a central role in both the market rout and the ensuing rebound. The Dow peaked at 26,828 on October 3, the day Fed chief Jerome Powell told PBS that interest rates are "a long way" from neutral, which is the level where they're neither slowing nor boosting the economy. Investors grew nervous that the Fed was raising borrowing costs faster than the economy could handle.

Powell added to the jitters on December 19 when he signaled little flexibility in the Fed's policies.

But the Fed has since come to the rescue by offering more soothing guidance. On January 4, Powell pledged that the Fed will be "patient" as it watches the

economy evolves. He added the Fed is "always prepared" to shift its stance if needed. Those comments helped propel the Dow 747 points, or 3.3%.

"The Fed was the primary reason for the downturn — and for the reversal in sentiment," said Joy.

The VIX volatility index plunged on Wednesday below 20 for the first time in a month. And the CNN Business Fear & Greed Index has finally moved out of "extreme fear."

Still, stocks have a long way to go before recovering all of the ground lost during the slide. The Dow remains almost 3,000 points away from its record high.

### **Jobs report, valuations help**

The December jobs report eased economic jitters by showing that the US labor market remained very strong at the end of 2018. American companies added 312,000 jobs last month, blowing away estimates.

Of course, the jobs report is considered a coincident or lagging indicator. More forward-looking gauges, most notably the ISM manufacturing report, point to potential trouble ahead.

The trade war is the big X-factor. Investors were encouraged this week by trade negotiations in Beijing that unexpectedly stretched into a third day.

US officials didn't make clear on a statement Wednesday just how much progress was made. But Wall Street is hoping that economic and market trouble in both the United States and China will force the two sides to reach a deal.

### **Oil prices, junk bonds rally**

In hindsight, it's clear that the Christmas Eve massacre on Wall Street brought stocks to unsustainably low levels.

"Unless the US was about to fall into recession, it was highly likely that the market had moved too far and would rebound," David Kelly, chief global strategist at JPMorgan Funds, wrote to clients Monday.

The S&P 500 plummeted to just 13.5 times projected earnings, well below the 25-year average of 16.1, according to Kelly.

At those multiples, even some bears were sniffing around for bargains.

"Valuations have reached an attractive level at the index level for the first time in years," Michael Wilson, chief US equity strategist at Morgan Stanley, wrote in a report Monday. Wilson had been warning for a market downturn for months.

Selling may have also been overdone in the oil patch. US oil prices climbed back above \$50 a barrel on Wednesday, leaving them on track for an eight-day win streak. That hasn't happened since July 2017.

Even junk bonds have benefited from the recovery. After losing ground last year, US high-yield bonds have returned 2.6% so far in 2019. That's the best start to a year since 2009, according to UBS.

### **More 'hurdles' to clear**

So is it safe to say the market correction is over? Maybe not.

Markets would likely come under renewed pressure if US-China trade talks falter, the Fed sounds a more aggressive tone or the global economy slows more than feared.

The bottoming process is typically messy, with markets often re-testing previous lows.

"It's a strong rebound and very encouraging — but not conclusive. You have to be a little circumspect," said Ameriprise's Joy.

Wilson warned of further "hurdles" to clear, including more negative economic and earnings data and the need for the Fed to shift from a more dovish tone to more dovish action.

"We don't think it's time to blow the all-clear signal yet," he wrote.

## **5. What the latest insolvency statistics reveal**

**[January 9, 2019]** At first glance, the latest insolvency data appear to show that rising interest rates are taking a toll on Canadians' finances. But a closer look reveals an overall declining trend in insolvencies.

The Office of the Superintendent of Bankruptcy Canada says the number of consumer insolvencies in November rose by 5.2% from a year ago, and business insolvencies increased by 8.9%.

The Bank of Canada raised its key lending rate five times since the middle of 2017, potentially explaining the year-over-year increase.

However, important to assessing the data is knowing that insolvencies comprise both bankruptcies and proposals. The latter are offers to creditors to settle debts under conditions other than the existing terms, and don't necessarily turn into bankruptcies, says Derek Holt, vice-president and head of capital markets economics at Scotiabank, in a report.

Breaking apart the two categories indicates that "consumer bankruptcies remain very well behaved," Holt says.

For example, for the 12-month period ending Nov. 30, the total number of bankruptcies and proposals grew by 2%, with consumer bankruptcies falling by 5% and proposals increasing by 8.4%.

Offering more detail, the Scotiabank report graphs data confirming that consumer bankruptcies have been on an overall downward trend since 2010. And proposals have been on an upward one, which Holt doesn't find



concerning, considering new mortgage stress-testing rules introduced last year.

“A rise in proposals was expected post OSFI’s B20 stress testing changes, as renewals would be more difficult in the tails of indebtedness,” Holt says in the report. “It is misleading to attribute the rise in proposals as just a function of higher rates.”

In fact, he says the increase in proposals is “a reflection of one of the great relative strengths of the Canadian banking system versus, say, the U.S. system.” Canada’s system is more flexible, and proposals tend to get worked out, he says.

For business insolvencies, despite November’s year-over-year increase of nearly 9%, “business bankruptcies are also very well behaved toward cycle lows, but this fact tends not to make headlines,” Holt says. Business proposals increased in November, but even that is just one month in an overall declining trend, he says.

Business insolvencies for the 12-month period ending Nov. 30, 2018 decreased by 0.6% compared with the 12-month period a year prior.

## **6. Luxury home sales fall in 2018**

**[January 9, 2019]** Sales of luxury properties fell in three of Canada’s biggest cities last year as homebuyers retreated amid tightened mortgage guidelines and higher interest rates, according to a report by Sotheby’s International Realty Canada.

The report released Wednesday found that Vancouver, Toronto and Calgary saw large drops in high-end real estate sales in 2018 as the markets dealt with a number of headwinds including tighter supply, higher foreign buyers’ taxes and strained economic conditions due to the falling price of crude.

“There were a series of policy initiatives that were put in place [... and] what we’re seeing now is that the combination of these things has taken hold and has delivered a soft landing that [governments] were hoping to see,” said Brad Henderson, president and CEO of Sotheby’s International Realty Canada.

The real estate brokerage said there continues to be rising consumer anxiety in the Vancouver housing market about the “unintended outcomes” of the government intervention.

Last year the B.C. government increased the foreign buyer tax to 20% and expanded its geographical area, raised school taxes for homes valued over \$3 million and launched new taxes on speculation and empty homes.

The Sotheby’s report—which looked at the high-end housing market in Toronto, Vancouver, Calgary and Montreal—found that the number of homes

that were sold for \$1 million and higher was down 26% in Vancouver. While home sales priced \$4 million and more fell 49% year-over-year.

In Calgary, sales of homes for \$1 million and more fell 10% in 2018 as crude oil prices plunged in the last quarter of the year. Only one home sold for more than \$4 million in that city in 2018.

In the Greater Toronto area, sales of luxury homes worth \$1 million and more declined 31%, while sales of homes over \$4 million and more fell 40% last year. In the city of Toronto, sales of homes over \$1 million fell 19%, while sales of over \$4 million and more dropped 39%.

Henderson pointed out that the figures were drastic because it compared “uncharacteristically soft sales” in the first quarter of 2018 when a number of housing policy changes came into effect with a “record-setting performance” of the first quarter of 2017.

He said it’s important to note that the Toronto market picked up traction in the back half of 2018, a sign that it is still buoyed by population gains and a steady economy.

Sotheby’s said Montreal was an anomaly for luxury sales in 2018 even though it indicates there are signs that the momentum is beginning to plateau in Quebec’s largest city. Montreal home sales over \$1 million and more increased 20% year over year, while homes sold for more than \$4 million fell 8%, the report found.

The brokerage also noted that the top-tier condo market across the country saw strength in 2018 due to other property types moving out of financial reach for many buyers, and baby boomers looking to downsize from their homes.

### **High-end real estate outlook for 2019**

Sotheby’s warned that although the high-end real estate market nationwide will continue to be supported by stable population growth, volatility in stock markets may shake consumer confidence in the coming year.

Henderson said Sotheby’s expects there to be continued downward pressure in the high-end Vancouver and Calgary real estate markets due to the lagging oil price and the foreign buyer taxes.

He expects to see growth in both the Toronto and Montreal markets in 2019, but not at the unprecedented pace seen in the past few years.

“The lack of listings is frustrating the market a bit,” said Henderson. “It will cause upward pressure on price, but it will be in the single digits, not the double digits. Until there is more stability and confidence in the market, we won’t see the number of listings increase significantly in Toronto.”

## **7. BoC holds interest rate, views oil slump as temporary soft patch**

**[January 9, 2019]** The Bank of Canada left its trend-setting interest rate unchanged at 1.75% Wednesday as the sharp decline in oil prices temporarily dims its economic outlook for the coming months.

Before long, however, the central bank expects the economy to expand with renewed vigour. More rate hikes, it stressed, will be necessary “over time.”

In its first policy announcement of 2019, the bank said the recent drop in crude prices will result in slower-than-expected growth in an economy that has otherwise been performing well.

The bank is now projecting growth to be just 1.7% in 2019, down from its October forecast of 2.1%—but it remains optimistic the economy will begin to strengthen again as early as the second quarter of this year.

“The drop in global oil prices has a material impact on the Canadian outlook, resulting in lower terms of trade and national income,” the bank said in a statement.

“Looking ahead, exports and non-energy investment are projected to grow solidly [...]. Indicators of demand should start to show renewed momentum in early 2019, leading to above-potential growth of 2.1% in 2020.”

The business-investment lift, the bank said, will get a boost from Ottawa’s recently announced tax changes to allow companies to write off a bigger share of the cost of new assets in the year they are purchased.

The big question, however, is what this will all mean for the pace of future interest-rate hikes.

Governor Stephen Poloz has been gradually raising the rate since mid-2017 to keep inflation from rising too high.

The timing of its next hike will depend on several factors, the bank said, and there will be a particular focus on developments in the oil markets, the Canadian housing sector and global trade policy.

The Bank of Canada has estimated it will no longer need to raise the rate once it reaches a “neutral” level of between 2.5 and 3.5%.

“Governing council continues to judge that the policy interest rate will need to rise over time into a neutral range to achieve the inflation target,” the bank said.

CIBC chief economist Avery Shenfeld said in emailed commentary that, with the central bank continuing to say rates must rise to the range of 2.5% to 3.5%, “the statement is more hawkish than what markets were pricing in,” and is bearish for fixed income and slightly bullish for the loonie.

**Other factors cited by the BoC**

In addition to the oil slump, consumption and housing investment were underlined as weaker than expected in large part due to higher borrowing costs and stricter mortgage guidelines. But household spending is expected to continue to be supported by other factors, the bank said in its latest monetary policy report, also released Wednesday.

The bank listed these factors as population growth fuelled by immigration, low unemployment rates, cheaper gasoline prices and wage gains.

It also pointed to several areas of uncertainty—the persistence of the crude-price drop, the extent of its impact on non-oil-producing regions, how household spending adjusts to previous interest-rate hikes and tighter mortgage rules, and global trade developments such as the U.S.-China conflict.

The bank projects growth in the fourth quarter of 2018 to be 1.3%, compared with its earlier prediction of 2.3%. Growth is expected to be just 0.8% over the first three months of 2019.

Canada's sharp deceleration in wage growth since last spring has also been highlighted by experts as a concern for the economy—particularly since the tightened labour market should translate into higher wages.

The bank addressed the issue Wednesday by saying national wage-growth figures have been weighed down by weaker numbers in the oil-producing provinces. The rest of the country has shown a steady level of wage growth in recent years and the bank remains hopeful it will pick up its pace.

The bank estimates the oil slump, which began last summer and has seen prices recover in recent weeks, will reduce the level of Canada's gross domestic product by 0.5% by the end of 2020. The economic impact of the decline is expected to be about one-quarter as large as the 2014-16 oil shock, the bank said.

## **8. Small biz owners get runaround from Service Canada: study**

**[January 8, 2019]** Only one-third of small business calls to Service Canada result in accurate, adequate information on the first try, a Canadian Federation of Independent Business (CFIB) study has found.

Overall, however, the Service Canada call centres scored a B-. The study praised the centres' professionalism, but cited accuracy and agent accountability as areas for improvement.

From May to July 2018, CFIB reps in six provinces made 205 calls to the Service Canada call centre and the Employer Contact Centre. Only 198 calls went through. Of those calls, reps deemed 34% of the answers to be complete,

17% as incomplete and 7% as incorrect. Forty-one percent of calls were referred to another department.

“It’s alarming that so much of the information small business owners are getting from Service Canada could be incomplete or outright wrong,” said Corinne Pohlmann, CFIB senior vice-president of national affairs, in a release. “They’re looking to the government to make sense of the complex regulatory system it sets out for them. If Service Canada’s own agents can’t help them find the right information, it can be harmful to the small business and its employees.”

Service Canada provides support on issues such as employment insurance, records of employment and labour market impact assessments. The federation pointed out that many small businesses do not have HR departments and rely on the call centres.

In terms of accountability, CFIB callers found that Service Canada agents only provided their first names, and in 14% of cases, the agent said their name too quickly or not at all. The federation said that such practices make it “difficult to hold [call centres] accountable for their answers and service.” Instead, it recommends implementing a mandatory ID system for agents, similar to the Canada Revenue Agency’s system.

Other recommendations from the CFIB study include:

- improving staff training, particularly on new developments in small business issues;
- reducing the target time for an Employer Call Centre call to be answered from 10 minutes to five minutes;
- sending callers webpages during calls, as opposed to after the call happens, so that callers can verify their understanding during the call;
- allowing agents to directly transfer calls between departments so callers do not have to hang up and start again.

The federation also assessed the CRA’s helpline in 2010, 2012 and 2016, giving it a C- all three years.

**Have a nice and fruitful week!**

To Unsubscribe Click [Here](#)