

Taking Stock with Steele

Your Monthly Newsletter

The purpose of this newsletter is to share insights and expertise. Our goal is to ensure that our clients are well-informed of changes affecting local business decisions and our investment recommendations.

We believe Knowledge Pays and we want our knowledge to help pay for you.

ARE CANADIAN HOUSE PRICES IN A BUBBLE? PROBABLY NOT SPECIFICALLY

For years, economists, both professional and armchair, have claimed that the Canadian housing market is unaffordable and is due for a correction. Here's our take.

The Canadian house price to gross income ratio has averaged ~3.5x over the past 35 years and currently sits at ~6.5x. Canada's second hottest market, Toronto, had a house price to gross income ratio of ~4.5x over the past 35 years and it currently sits at ~8.8x. The 5-year mortgage rate special averaged ~8% over the past 35 years and currently sits at ~2.2%. Below we outline housing affordability as we see it.

| A Glance at Affordability of Canadian Housing | Canada | | Toronto | |
|---|-----------------|-----------------|-----------------|-----------------|
| | Average | Current | Average | Current |
| Price to Income Ratio | 3.5x | 6.5x | 4.5x | 8.8x |
| Price (in today's \$) | \$350,000 | \$650,000 | \$450,000 | \$880,000 |
| 5-Yr Mortgage Rate (Special) | 8.00% | 2.20% | 8.00% | 2.20% |
| Taxes (1% of Price) | \$3,500 | \$6,500 | \$4,500 | \$8,800 |
| Annual Interest* + Taxes | \$31,500 | \$20,800 | \$40,500 | \$28,160 |

*for simplicity, we assume a 25 year mortgage and that the house is 100% mortgaged

As you can see, **the carrying costs (e.g. mortgage interest plus taxes) of owning a home are far lower than in the past.** Considering the average house size has risen materially over the past few decades, it appears that the value provided by housing today is greater than in the past. While higher prices translate to higher monthly payments, which has a negative effect on household cash flow, the bulk of mortgage payments today go toward building equity. If we can conclude that Canadian housing prices are not excessive due to lower than average carrying costs and that the additional equity achieved over time, relative to the past, is secure, today's higher than normal mortgage payments do not translate to higher than normal affordability.

The bear case on Canadian housing is reliant on rising interest rates. For current house prices to be considered **on par** with historical valuations in terms of carrying costs over the life of the loan, 5-year fixed special mortgage rates would have to average **~5% for Canada and ~4.6% for Toronto** for the twenty years following the first five year term.

The key downside in today's environment is that more housing equity is being built at a time of historically low expected returns on real estate. That said, given the leverage provided by real estate and the low expected return for lower risk and interest rate sensitive assets (e.g. bonds), real estate should perform well relative to assets with a similar risk profile. While saving for larger down payments and higher mortgage payments may be difficult, house prices (outside Vancouver) appear reasonable relative to historical valuations and other asset classes.

Current Rates & Data

Govt of Canada

| | |
|---------|-------|
| 90 day | 0.48% |
| 1 year | 0.51% |
| 2 year | 0.51% |
| 5 year | 0.57% |
| 10 year | 0.98% |
| 30 year | 1.60% |

U.S. Treasury

| | |
|---------|-------|
| 90 day | 0.27% |
| 1 year | 0.52% |
| 2 year | 0.68% |
| 5 year | 1.06% |
| 10 year | 1.48% |
| 30 year | 2.21% |

Canada Prime Rate

2.70%

U.S. Prime Rate

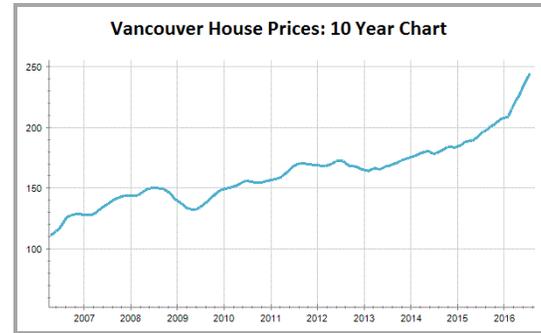
3.50%

Exchange Rates

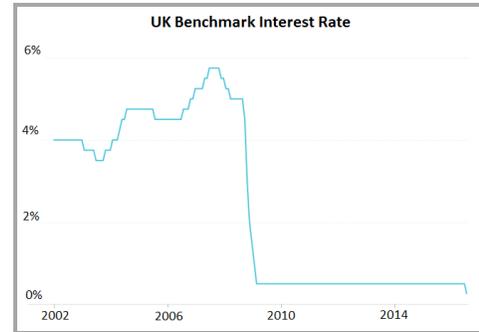
| | |
|---------|-------|
| CAD/USD | 0.772 |
| USD/EUR | 1.120 |
| JPY/USD | 101.0 |

ECONOMIC TIDBITS B.C. LAW MAKERS TARGET FOREIGN REAL ESTATE BUYERS & BOE CUTS RATES

- In an effort to cool the metro Vancouver housing market, B.C. lawmakers enacted a 15% tax on foreign real estate buyers. Deal volumes spiked immediately after the announcement as foreign buyers rushed to complete deals prior to the law's commencement. Some commentators noted that the deal is in violation of NAFTA and could have consequences for the federal government.



- The Bank of England, led by former Bank of Canada governor Mark Carney, announced that it is cutting its key interest rate to 0.25% (from 0.50%), providing £100 million in loans to UK banks and is expanding the volume of quantitative easing (QE) by £70 billion and is now purchasing of corporate bonds as part of its QE program. The move was in response to the economic malaise brought on by the Brexit vote.



LE JIT A "JUST-IN-TIME" RUNDOWN OF OUR CURRENT INVESTMENT THEME

Within a Market Full of Overpriced Low Volatility Equities, a Few That Are Trying to Find a Trough

- **Jean Coutu (PJC.A)** and **Algoma Central (ALC)** are two ideas related to this theme.
- **Jean Coutu** is the largest drugstore chain and one of the largest generic drug manufacturers in Quebec. Jean Coutu shares are down 35% from their late 2014 high as a result of Quebec's Bill 81 which is expected to pressure generic drug margins. Despite trading in line with their historical valuation at 17x trailing earnings, Jean Coutu shares appear attractive as most consumer staples peers trade at much higher valuations (20%-60% higher), Bill 81 is unlikely to have a lasting effect as most provinces who have adopted similar legislation scrapped it due to supply issues and the company has a net cash and monetizable real estate value of over \$600 million which can be accessed to buy back stock.
- **Algoma** is the largest bulk shipping company operating in the Great Lakes. Algoma is experiencing a combination of transportation sector contagion and incredibly weak dry bulk shipping rates. Algoma is down almost 40% from its mid-2015 high, roughly in line with other small industrial and freight shipping companies. Algoma shares should rebound when North American economic growth rebounds. Algoma is in an enviable position within the dry bulk shipping industry as most dry bulk shippers are at or are near bankruptcy and Algoma has an opportunity to become one of the larger dry bulk shippers in the world if it maintains its healthy balance sheet and continues to grow its ocean going business through acquisition.
- Feel free to ask a member of our team for more information on these securities.

JEANNINE'S TIP O' THE MONTH Successful Aging

Lately, we are having more conversations with clients about planned and sometimes unexpected care needs for themselves or their aging loved ones. Laura is a **Certified Professional Consultant on Aging (CPCA)** and has expertise working with seniors to anticipate, plan and implement smooth life transitions. Contact us so that we can equip you with valuable information.

This newsletter has been brought to you by Steele Wealth Management

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