

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.

HOME CAPITAL GROUP'S PLIGHT IS HOME CAPITAL THE COUNTRYWIDE OF CANADA?

On April 19, the Ontario Securities Commission (OSC) announced it would pursue an administrative proceeding against Home Capital Group and three key personnel. That announcement triggered a rapid decline in Home Capital's deposit base, which consists of high interest savings account (HISA) and guaranteed investment certificate (GIC) products. From April 20 to May 9, Home Capital's HISA deposits fell from ~\$2 billion to ~\$150 million and GIC deposits fell by ~\$400 million for a total decline in the deposit base of ~\$2.25 billion. Over the same period, Home Capital shares fell by over 60%.

Why Does Home Capital's Deposit Base Matter?

As of December 31, Home Capital had ~\$18.9 billion in mortgages and ~\$1.2 billion in cash offset by ~\$15.9 billion in deposits, ~\$1.2 billion in shareholder's equity and ~\$3 billion in resale commitments and debt. When an investor sells a HISA or a GIC matures, Home Capital must pay the investor the principal and interest within a day. As Home Capital saw its deposit base fall by ~\$2.25 billion and the company only had \$1.2 billion in available cash, it had to raise over \$1 billion to fund the payments to HISA and GIC depositors. Home Capital must raise the cash to continue operating.

How can Home Capital Raise Cash and Continue Operating?

Home Capital has limited levers it can pull to raise cash. It can issue new equity or debt, attract new deposits or sell some of its mortgages. As raising equity is not ideal at the current share price and attracting new depositors is unlikely given its current predicament, Home Capital opted for new debt financing (at an punishing interest rate, mind you) and announced an agreement to sell up to \$1.5 billion in mortgages.

Is the End of the Housing Market Boom Nigh with Home Capital on the Ropes?

The run on deposits at Home Capital was initially contagious sparking a rapid decline in the shares of Equitable Group, the other non-prime lender with a similar business model. The big six Canadian banks have since provided Equitable Group with a \$2 billion loan at an attractive rate of just over 2%. This loan will likely be enough to shore up confidence at Equitable Group and allow the company to continue funding their business with HISAs and GICs. It is fair to remember that Home Capital's decline relates to an OSC investigation and a crisis of confidence, not an uptick in mortgage defaults like in the US in the mid-2000s. In fact, mortgage defaults are at an all-time low and given the rapid rise in house prices, Home Capital's mortgage assets look attractive. While Home Capital's deposit base and its ability to originate and renew mortgages will likely shrink, effectively raising interest rates for non-prime borrowers, we believe the impact on the greater housing market will be minimal. A recession is likely required for a house price correction.

Current Rates & Data

Govt of Canada

90 day	0.48%
1 year	0.61%
2 year	0.70%
5 year	1.03%
10 year	1.59%
30 year	2.22%

U.S. Treasury

90 day	0.88%
1 year	1.11%
2 year	1.33%
5 year	1.90%
10 year	2.37%
30 year	3.01%

Canada Prime Rate

2.70%

U.S. Prime Rate

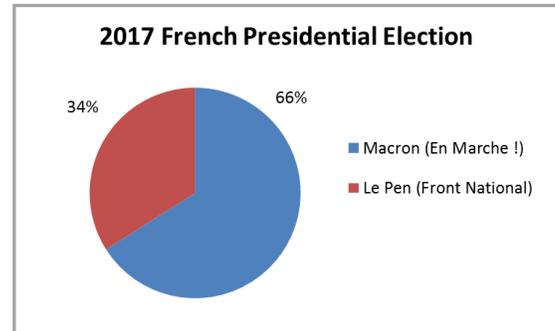
4.00%

Exchange Rates

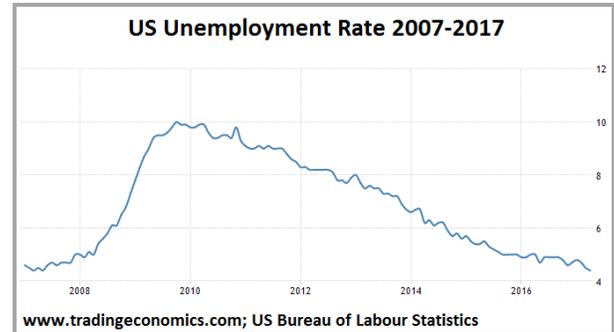
CAD/USD	0.731
USD/EUR	1.087
JPY/USD	114.1

ECONOMIC TIDBITS MACRON HANDILY WINS FRENCH ELECTION & JOBS: SOLID APRIL AFTER WEAK MARCH

- On May 7, Emmanuel Macron defeated Marine Le Pen for the French presidency. Macron garnered 66% of the vote, a signal that France rejects the populism that has captured the hearts and minds of voters in the West. Macron's victory shifts France from the left to the center. Macron is more business friendly than his predecessor was while maintaining liberal social policy and France's place in the EU.



- The US economy added 211,000 jobs in April versus an expectation of 185,000 and March's figure of 98,000. This strong jobs report pushed the US unemployment rate to a 10-year low and pushed the probability of a June US interest rate hike to ~85%. Canadian employment data was also positive in April pushing the Canadian and Ontario unemployment rates to a 9-year low and a 16-year low, respectively.



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

Two Low Volatility Canadian Financials Trading Near Their Pre-Trump Rally Levels

- **Sun Life Financial (SLF)** and **Great West Lifeco (GWO)** are two ideas related to this theme.
- **Sun Life** is the third largest life insurance company in Canada by revenue. Sun Life also derives 40% of its earnings from its large wealth management business. Sun Life trades at ~11.5x trailing earnings, a discount to its Canadian life insurer peers as well as the Canadian banks. Sun Life's weak performance of late is due to higher than expected policyholder usage, which is likely to be transient, and the company's operating performance will likely improve in the coming quarters. Sun Life now trades at the low end of its historical valuation range and is trading near its pre-Trump rally level, when interest rate expectations were much lower. Due to its life insurance policy commitments, Sun Life benefits when interest rate expectations rise. Most financial companies continue to trade well above pre-Trump rally levels.
- **Great West** is the second largest life insurance company in Canada by revenue. Great West operates a large group benefits business and has meaningful exposure to the UK. Great West trades at ~13.2x trailing earnings roughly in between the valuation of its key peers Sun Life and Manulife. On a historical basis, Great West trades at a fair valuation relative to life insurance peers but appears underpriced relative to other financial companies. Like Sun Life, Great West has experienced weak performance because of higher than expected policyholder usage and trades near its pre-Trump rally level.
- Feel free to ask a member of our team for more information on these securities.

JEANNINE'S TIP O' THE MONTH T+2 Cycle Change Effective September 5, 2017

Trade settlement for stocks, debentures, ETFs and mutual funds is currently three days between trade execution and settlement. Effective September 5, 2017, the time between trade execution and settlement will be two days industry wide. Every securities firm in Canada and the US will be moving to the shortened settlement period. This change aims to realize a more efficient and safer service for investors and align Canada with the global marketplace.

This newsletter has been brought to you by Steele Wealth Management

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As the investment products listed in this newsletter may not be appropriate for everyone, a recommendation would only be made following a personal review of an individual's portfolio and risk tolerance.