Volume 8, Edition 17

Pathfinder Investment Outlook

For the week ending August 31st, 2018

Recap & Outlook: Vancouver Housing – Part III

Over the next four weeks, we readdress a relevant domestic issue: Vancouver housing and whether it is a good investment. Over the next four weeks, we cover four topics: 1) Foreign Capital, 2) Interest Rates and Lending Standards, 3) State of the Current Market, and 4) Our Conclusion

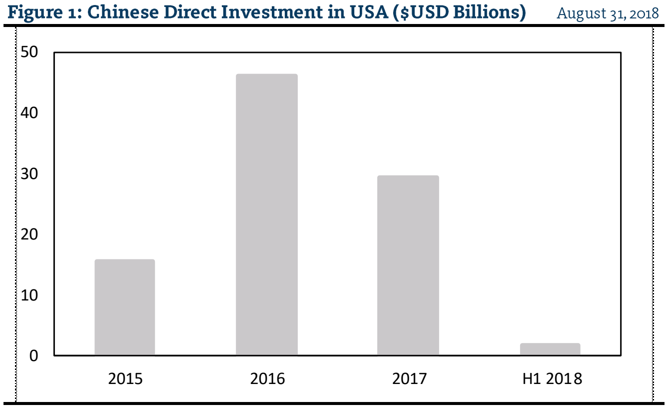
These topics are a follow-up to the reports we wrote in July 2015 and in August 2016. In those reports, we characterized local real estate as undoubtedly expensive and an asset that lacks the characteristics we look for in an attractive investment. By our definition, we concluded that owning local real estate was not an investment but a speculation on the continuation of foreign capital flow, low interest rates, and low lending standards. Let's start with foreign capital this week:

Foreign Capital

Foreign capital has driven Vancouver real estate: In our opinion, the biggest driver behind Vancouver's booming real estate market has been the flow of foreign capital into the market. We have heard that a large proportion of foreign capital was not buying real estate for investment or residential purposes. Instead, we believe foreign capital was using local real estate to "hide" wealth, similar to a Swiss bank. This is significant because this type of buyer is willing to pay significantly more for this type of anonymity similar to Swiss bank account holders willing to pay much higher banking fees for secrecy.

Foreign capital has become constrained: Based on this analysis, the continued free flow of foreign capital seems instrumental in maintaining Vancouver real estate prices. Importantly, over the last two years, we have seen significant incremental constraints on foreign capital buying local real estate. This has come from China restricting outflows and B.C. restricting inflows.

Figure 1: Chinese Direct Investment in USA ($USD Billions) August 31, 2018



Source: Rhodium Group, Pathfinder Asset Management Limited

China restricting capital outflow: China has moved to significantly restrict capital leaving its country. China previously implemented a rule that individuals could not move more than USD$50,000 per person per year out of China. However, the rule lacked effective enforcement and individuals could “import” well in excess of the quota through an underground industry we’ll call “shadow banking”. With its slowing economy, China recently moved to significantly scrutinize the “shadow banking” industry; China’s goal is to keep as much capital as possible in its country. As an example, with Canadian cooperation, China constructed a major data application that tracks Chinese capital entering Canada by bank account, name, and address. If more than one USD$50,000 deposit is made into or within an account or address respectively, the government flags this account. Previously, an individual could get family and friends to each send USD$50,000 to a single bank account in Canada, allowing an individual to flow well in excess of the quota out of China. There were even service offerings for larger transfers at a healthy fee. Now, China is restricting capital outflow to all countries and in Figure 1, you can see the drastic collapse in Chinese foreign direct investment into the United States. We believe a chart of Chinese foreign direct investment into Vancouver real estate would be similar, if not worse.

B.C. restricting foreign capital Inflow: Locally, B.C. put its own spotlight on foreign capital. Over the last two years, we observed a citizen up rise against foreign capital and unaffordable real estate. As a response, the provincial government implemented a 15% tax on foreign real estate buyers - a meaningful annual tax on individuals who own local real estate but do not report local income. In addition, Vancouver implemented a significant annual tax on homes that are left vacant. Reading between the lines, all taxes are focused on individuals relying on foreign capital.

B.C. appoints provincial head of anti-money laundering: The province also appointed a new head of anti-money laundering, who, upon review of the reports stated “I am deeply troubled by the money being laundered through the province’s housing market”. This ties into our opinion that a large proportion of foreign capital was not buying real estate for investment or residential purposes but to “hide” wealth. The new minister expects to “tackle” the issue shortly.

“**This means that”** It is tough to quantify how all of this will impact foreign capital entering the city to buy real estate. However, one thing seems certain; the free-flow of foreign capital that was instrumental to the booming domestic housing market seems to have ended. Next week we report on higher interest rates and tighter lending standards and how they are impacting mortgages for homeowners.

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Pathfinder Investment Outlook

For the week ending September 7th, 2018

Recap & Outlook: Vancouver Housing – Part III

We continue readdressing a relevant domestic issue: Vancouver housing and whether it is a good investment. As a reminder, we are covering four topics: 1) Foreign Capital, 2) Interest Rates and Lending Standards, 3) State of the Current Market, and 4) Our Conclusion.

These topics are a follow-up to the reports we wrote in July 2015 and in August 2016. In those reports, we characterized local real estate as undoubtedly expensive and an asset that lacks the characteristics we look for in an attractive investment. By our definition, we concluded that owning local real estate was not an investment but a speculation on the continuation of foreign capital flow, low interest rates, and low lending standards. This week, we comment on interest rates and lending standards.

<u>**Interest Rates and Lending Standards**</u>

Interest rates have risen: The interest rate on a five year government bond is important because it determines the interest rate charged on mortgages. This key interest rate has increased from a low of 0.57% in January 2016 to 2.24% today.

- ***Mortgage payments are increasing:*** To put the above in perspective, the above rate increase applied to a typical 25 year mortgage would make the monthly mortgage payment ~$2,400 vs. ~$2,000 previously.

- ***Fixed rate mortgages:*** Even fixed rate mortgages (typically 3-5 year term) are subject to renewals based on the interest rate at that time. Today, Canadians will be renewing their fixed rate mortgages at a higher interest rate (and higher mortgage payment) for the first time in over a decade.

- ***Can Vancouverites afford this?*** With many Vancouverites previously borrowing the maximum mortgage they can afford, this rate increase could make many related monthly mortgage payments unaffordable.

- ***Rates to keep rising?*** With inflation accelerating, many economists believe we have reversed the 37 year trend of lower interest rates and are in the early-stages of a new trend of rising interest rates. If this happens, mortgage payments will continue increasing.

Lending standards have tightened: Since our August 2016 report, the government has significantly restricted who and how much banks lend to. This began in the fourth quarter of 2016 with new regulations on mortgages insured by CMHC (borrower making <20% down payment). Incremental regulations came in January 2018 when OFSI scrutinized uninsured Canadian mortgages (borrower making >20% down payment). These regulations were:

- borrowers must qualify for a mortgage based on a higher than current interest rate;
- lenders are to be more diligent in the income verification of borrowers;
- borrowers can't borrow to make their down payment.

This means that a prospective home buyer who could get access to a $1,000,000 mortgage previously can now only access a $750,000 - $900,000 mortgage. Also, the stricter income verification means that many Vancouver based borrowers can no longer access credit.

"**This means that"** changes in government based lending standards have significantly restricted who and how much banks may lend to Canadians to buy real estate. Higher interest rates equal higher mortgage payments which can make prior mortgages unaffordable. While interest rates are difficult to predict, many economists believe interest rates will continue rising. In summary, the era of loose lending standards and low interest rates instrumental to the booming domestic housing market may be ending. Next week, we report on how the changes in foreign capital, interest rates and lending standards are currently impacting sales and prices in the Vancouver real estate market.

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Pathfinder Investment Outlook

For the week ending September 14th, 2018

Recap & Outlook: Vancouver Housing – Part III

We continue to address a relevant domestic issue: Vancouver housing and whether it is a good investment. As a reminder, we are covering four topics: 1) Foreign Capital, 2) Interest Rates and Lending Standards, 3) State of the Current Market, and 4) Our Conclusions.

These topics are a follow-up to the reports we wrote in July 2015 and in August 2016. In those reports, we characterized local real estate as undoubtedly expensive and an asset that lacks the characteristics we look for in an attractive investment. By our definition, we concluded that owning local real estate was not an investment but a speculation on the continuation of foreign capital flow, low interest rates, and low lending standards. This week, we comment on the state of the current market.

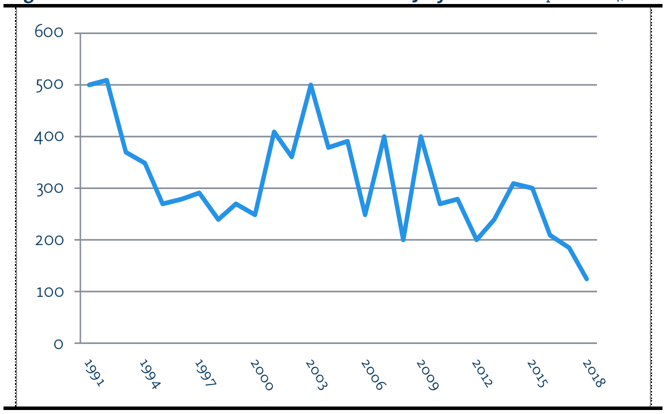
State of the Current Vancouver Real Estate Market

We previously concluded that local real estate was not an investment but a speculation on a continued supply of foreign capital, low interest rates, and low lending standards. In our last two Outlooks, we noted that foreign capital has become restricted, interest rates have risen, and lending standards have tightened. Therefore, if we are correct that these are the drivers of the local real estate market, we should expect a significant negative impact on the market today.

Volumes are at the lowest levels ever recorded: In July 2018, Vancouver saw 126 detached home sales. As can be seen in Figure 1, this is 50% below the 10 year average for July and the lowest amount of Vancouver detached home sales ever recorded. This record was subsequently broken in August 2018 where we saw just 116 detached home sales.

High inventories suggest a lack of buyers: The question is whether the lack of transactions stems from a lack of buyers or a lack of sellers. To that point, the inventory of Vancouver homes looking to be sold

Figure 1: Vancouver Detached Home Sales for July September 14, 2018



Source: REBGV, Pathfinder Asset Management Limited

hit a six year high in July. With a record number of sellers, the problem seems rooted in a lack of buyers.

Average prices are down, but averages are not reliable: In terms of pricing local real estate, the average price in July was 16% lower vs. the July 2017 figure. However, we caution that the mix of houses included in each month can significantly influence the average number. Regardless, with buyers scarce and inventories at a six year high, we worry that prices are not only correcting, but may also continue correcting.

"**This means that"** the state of the current Vancouver real estate market is dry. We believe this is a direct result of the new environment of restriction in foreign capital, higher interest rates, and tighter lending standards. Where we go from here is most important. We will report on our conclusions and outlook next week.

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Pathfinder Investment Outlook

For the week ending September 21st, 2018

Recap & Outlook: Vancouver Housing – Part III

We continue addressing a relevant domestic issue: Vancouver housing and whether it is a good investment. As a reminder, we are covering four topics: 1) Foreign Capital, 2) Interest Rates and Lending Standards, 3) State of the Current Market, and 4) Our Conclusions.

These topics are a follow-up to the reports we wrote in July 2015 and in August 2016. In those reports, we characterized local real estate as undoubtedly expensive and an asset that lacks the characteristics we look for in an attractive investment. By our definition, we concluded that owning local real estate was not an investment but a speculation on the continuation of foreign capital flow, low interest rates, and low lending standards. This week, we present our conclusions and outlook.

Our Conclusions and Outlook

There are no changes to our 2015 and 2016 conclusions:

1) ***Local real estate is not an investment:*** specifically, local real estate lacks the characteristics we look for in an attractive investment. Domestic real estate does not generate sufficient net rent to justify its price.

2) ***It's a speculation:*** specifically, we believe that owning local real estate is a speculation on the continuation of foreign capital flow, low interest rates, and low lending standards.

After observing the last two years, we have two incremental conclusions:

3) ***Tailwinds are now headwinds:*** specifically, foreign capital has become restricted, interest rates have risen, and lending standards have tightened. This is a stark contrast to the prior environment.

4) ***Key variables verified:*** specifically, we previously highlighted foreign capital, interest rates, and lending standards as the key drivers to the local real estate market. With the changing environment in these variables resulting in the drastic negative impact on the volumes and prices of local real estate, we have increased conviction verifying that these are the key drivers to Vancouver's real estate market.

We do not know for certain where Vancouver's real estate market goes from here. For some time, we have been warning that the asset class has more risk than reward:

Restriction on Chinese capital seems permanent: The length and level of sophistication China has gone through to restrict capital leaving their country makes us believe it is permanent.

Potential for much higher interest rates: Interest rates have just begun to rise. Previously, interest rates were in a downtrend for 38 years and some economists believe we have reversed that trend. Inflation has accelerated and looming trade wars would accelerate that further. Central banks can only combat inflation with higher interest rates.

Prices are too high! Local real estate prices deviated from a fundamental value many years ago. Like the US market in 2007, it would be a long fall back to a fundamental price.

Psychology is prone for a change: The psychology that accompany asset bubbles have been present in the real estate market. We've all heard the sayings: "it's better to own then rent"; "real estate only goes up in price"; "if I don't own I'll miss the market". There was similar rhetoric in the cryptocurrency asset bubble last year.

However, foreigners still want our real estate: There is still demand for Vancouver's real estate. The question is whether these buyers can access the foreign capital required.

Group of locals looking to buy: There are many locals currently renting but would be buying if prices were reasonable. However, this buyer is typically reliant on mortgages, interest rates, lending standards, and lower prices!

"**This means that"** at a minimum, we believe the great bull market in Vancouver's real estate is over. We wanted to highlight our thoughts so that clients know our opinion on an asset class that is typically important to them. The majority of our team rents and invests our savings in assets that meet the characteristics we look for in an investment. This includes real estate, just not in metro Vancouver.

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