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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:

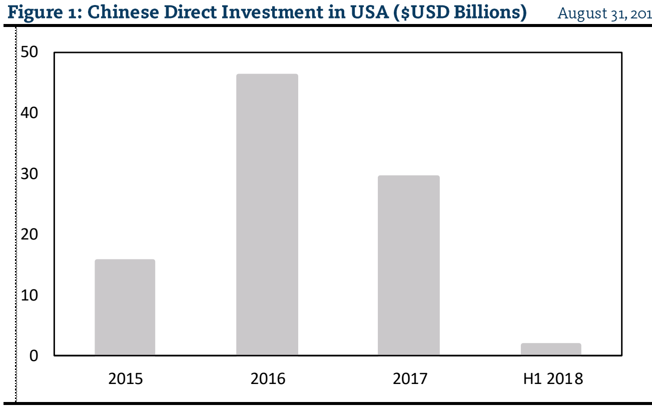
__Foreign Capital__

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.

China restricting capital outflow: China has moved to significantly restrict capital leaving its country. China previously implemented a rule that individuals could

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



Source: Rhodium Group, Pathfinder Asset Management Limited 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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Sources: Bloomberg, Pathfinder Asset Management Limited

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*All returns are time weighted and net of investment management fees. Returns from the Pathfinder Partners' Fund and Partners' Real Return Plus Fund are presented based on the masters series of each fund. The Pathfinder Core: Equity Portfolio and The Pathfinder Core: High Income Portfolio are live accounts. These are actual accounts owned by the Pathfinder Chairman (Equity) and client (High Income) which contain no legacy positions, cash flows or other Pathfinder investment mandates or products. Monthly inception dates for each fund and portfolio are as follows: Pathfinder Core: Equity Portfolio (January 2011), Pathfinder Core: High Income Portfolio (October 2012) Partners' Fund (April 2011), Partners' Real Return Plus Fund (April, 2013), and Partners' Core Plus Fund (November 2014).

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