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Third Time Unlucky?

by Avery Shenfeld

Canada seems to be coming out of its second brush with recession risks, but will it be a case of third time unlucky? The first close call was back in 2015, when we went through two consecutive quarters of falling real GDP after oil sector capital spending tumbled. That didn't count as a recession, because we escaped without a climb in the jobless rate, but it was enough to prompt two insurance rate cuts from the Bank of Canada.

The second soft patch was driven by a deceleration in global growth in the second half of 2018, a slump in Canadian home sales and related retailing, and a bottleneck that depressed Canadian heavy oil prices. That yielded a near zero growth rate in Q4.

But a pause on rate hikes by the Bank of Canada, early signs of a turn in China, and at least some reduction in Canada-US trade fears, seem to be keeping growth positive in Q1. Some adjustments to add flexibility in mortgage regulations while interest rates are higher might be helpful to cushioning the downturn now evident in housing (see pages 9-11).

A third brush with at least some recession risks lies in wait in 2020, when the US could be hit with a bit of fiscal restraint after having been lifted by tax cut and spending stimulus in 2018-19. Will Canada be lucky again? If so, it will have to have its longest run near full employment since the 1960s.

That feat is also rare among other countries (see pages 6-8), and those that managed it often built up excessive financial risks that deepened the next recession when it came.

That said, there are some reasons why Canada and the US could muddle through 2020 with sluggish but still positive growth. Both central banks seem to have wisely stepped to the sidelines and away from further rate hikes before it was too late.

On the trade front, Canada's exporters might get some relief if, as we expect, the Canadian dollar trades at somewhat weaker levels in 2020 and beyond. But if global growth sours more than in our base case for next year, perhaps due to a more heated trade war, policymakers in Canada will need to consider what steps to take to add domestic stimulus.

The lesson from other jurisdictions is that achieving a long expansion by leaning heavily on ultra-low interest rates and ever expanding household debt carries some risks. Putting a regulatory floor under mortgage qualifying rates if market interest rates tumble sharply could reduce those side effects by giving households cheaper mortgages while restraining mortgage sizes.

In addition, a heavier dose of fiscal stimulus, particularly at the federal level where Canada's debt service costs are well contained, might be a better approach.

Someone has to borrow and spend when tough times come, but putting the debt on the nation's books rather than on those of individual households could be the safer approach.

MARKET CALL

- In forecasting, as in poker, sometimes it pays to stick with the hand you've been dealt. We're standing pat with nearly all of what we laid out a month ago. These calls largely rest on a view that global growth indicators will look a bit better as winter turns to spring.

- A spring awakening, even if not a sign of even better things to come thereafter, will prove negative for fixed income markets, at least until the fading of US fiscal stimulus brings a return to rate cut risks in 2020, particularly in the US where we're showing a token ease next year as a placeholder for a more dovish Fed picture beyond 2019.

- We see the US dollar as has having room to give ground against many major currencies, in the lead up to a 2020 Fed ease. But after a rally on a better Q2 Canadian GDP outturn, the Canadian dollar looks likely to weaken off, and we're nudging our 2020 target more in that direction. The economy has held up well since 2008 despite a lackluster export sector and has steadily been a net borrower abroad without adding to an investment income deficit (see pages 3-5). But red ink in the trade balance will eventually test foreign appetites to continually offset that with additional Canadian investments, and we'll need a weaker loonie in 2020 as our key export market, the US, sees a further slowing.

INTEREST & FOREIGN EXCHANGE RATES

		2019				2020			
END OF PERIOD:		**16-Apr**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
	98-Day Treasury Bills	1.67	1.75	1.75	1.70	1.75	1.65	1.60	1.60
	2-Year Gov't Bond	1.63	1.70	1.80	1.75	1.70	1.50	1.60	1.50
	10-Year Gov't Bond	1.78	2.00	2.25	2.20	2.15	1.95	1.70	1.65
	30-Year Gov't Bond	2.08	2.25	2.30	2.30	2.25	2.20	2.10	2.00
U.S.	Federal Funds Rate	2.375	2.375	2.375	2.375	2.375	2.125	2.125	2.125
	91-Day Treasury Bills	2.42	2.45	2.50	2.40	2.30	2.20	2.15	2.10
	2-Year Gov't Note	2.41	2.55	2.65	2.60	2.55	2.30	2.35	2.35
	10-Year Gov't Note	2.59	2.85	2.95	2.90	2.85	2.70	2.65	2.60
	30-Year Gov't Bond	2.99	3.10	3.30	3.30	3.25	3.25	3.10	3.00
Canada - US T-Bill Spread		-0.75	-0.70	-0.75	-0.70	-0.55	-0.55	-0.55	-0.50
Canada - US 10-Year Bond Spread		-0.81	-0.85	-0.70	-0.70	-0.70	-0.75	-0.95	-0.95
Canada Yield Curve (10-Year — 2-Year)		0.15	0.30	0.45	0.45	0.45	0.45	0.10	0.15
US Yield Curve (10-Year — 2-Year)		0.18	0.30	0.30	0.30	0.30	0.40	0.30	0.25
EXCHANGE RATES	CADUSD	0.75	0.76	0.76	0.75	0.75	0.74	0.74	0.72
	USDCAD	1.34	1.31	1.32	1.34	1.34	1.35	1.36	1.38
	USDJPY	112	108	106	105	104	103	101	100
	EURUSD	1.13	1.15	1.16	1.18	1.20	1.23	1.23	1.24
	GBPUSD	1.30	1.32	1.33	1.37	1.41	1.46	1.46	1.46
	AUDUSD	0.72	0.73	0.73	0.74	0.75	0.76	0.78	0.78
	USDCHF	1.01	0.97	0.97	0.96	0.94	0.93	0.93	0.94
	USDBRL	3.90	3.60	3.65	3.80	3.85	3.95	3.90	3.80
	USDMXN	18.9	19.4	20.1	19.9	20.1	20.4	20.6	20.7

Borrow More, Owe Less: How Canada is Raking the Chips Abroad

by Avery Shenfeld

If you're feeling starved for a good news story about the Canadian economy, read on. Because, as it turns out, despite a decade of heavy net borrowing from abroad, Canada is in a much better international financial position than you would think.

When a country like Canada runs a trade deficit with the rest of the world, it has more players seeking to sell Canadian dollars to buy imports than there are foreigners buying Canadian dollars to purchase our exports. A current account deficit, which includes both trade and investment income flows, generates the same imbalance.

What offsets that, and keeps the overall balance of payments at zero, is a surplus on the capital account: more foreigners are buying Canadian dollars to buy our bonds, stocks or hard assets than we are selling to buy foreign assets. That gap represents net borrowing from the rest of the world. With our trade balance mired in the red, Canada has steadily piled on a mountain of $358 bn in additional net foreign liabilities since Q4 2008 (Chart 1).

Typically, that would mean an ever growing burden of higher interest or profit flows going to foreigners relative to what comes into Canadian hands from the rest of the world. But exactly the opposite has happened. Canada has actually been raking in the chips from international investment flows, reaping a growing pile of returns on its assets abroad that is now, for the first time in over a half century, on the verge of surpassing our quarterly payments to foreigners (Chart 2). What's been the secret sauce for Canada's ability to have the growth in our earnings abroad outstrip the payments we've had to send the other way?

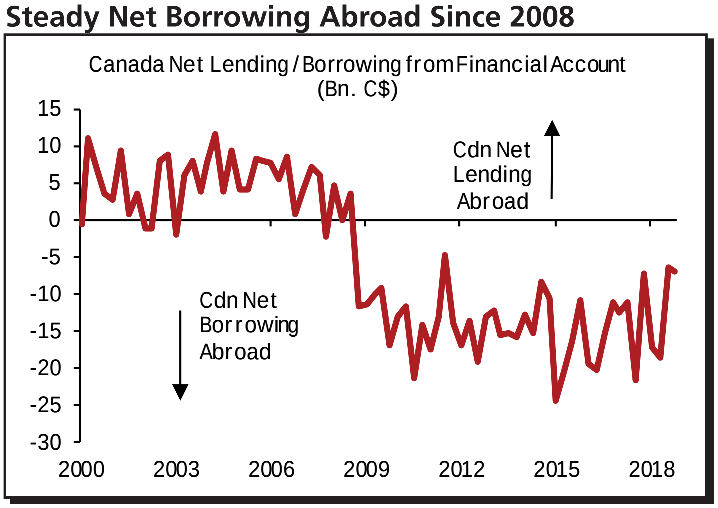
Asset Mix and a Weaker Loonie

Simply put, what we've bought abroad has earned a much higher rate of return than what foreigners have purchased in Canada. The exchange rate tells some of that story, at least since 2012, as the Canadian dollar has depreciated by 19% from its peak monthly level that year on a trade-weighted basis. At least some of what foreigners bought had interest payments accruing in Canadian dollars, while a Canadian institution owning US Treasuries, for example, would have harvested a big crop of FX gains in the value of payments back into loonies.

But as is the case for any mix of securities and hard assets, portfolio selection has been a major driver of

Chart 1

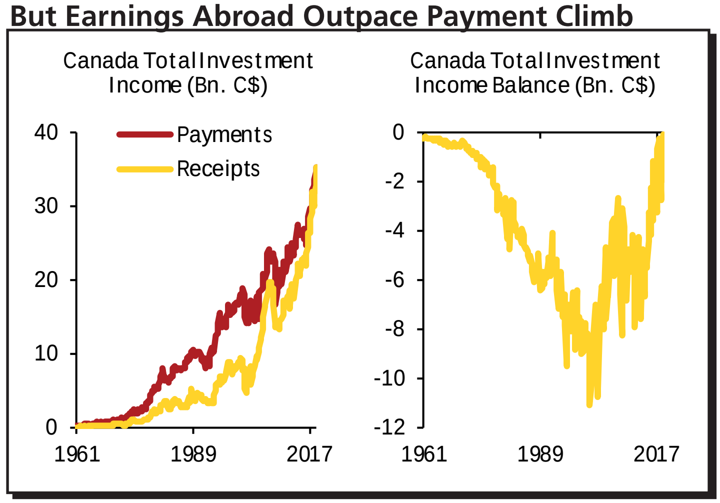
Steady Net Borrowing Abroad Since 2008



Source: Statistics Canada, CIBC

Chart 2

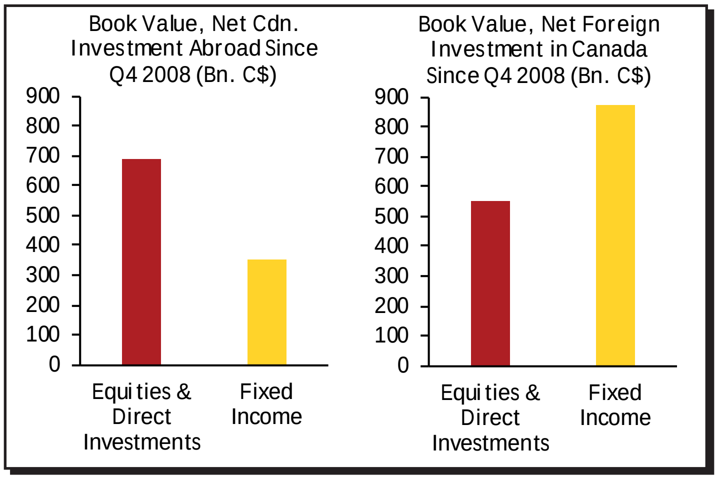
But Earnings Abroad Outpace Payment Climb



Source: Statistics Canada, CIBC

Chart 3

Different Mix In Canadian Foreign Assets vs. What Foreigners Bought in Canada



Source: Statistics Canada, CIBC

why Canada has been a winner in net investment income flows across our border. On the buying side of the ledger, Canadian households have diversified by accumulating foreign equities. Institutions, including our well stocked pension funds, have been big purchasers of foreign stocks and in recent years, hard assets like real estate, airports, and other infrastructure. And corporate Canada has joined in, with acquisitions in sectors like financial services, pipelines and power utilities.

In total, the net book value of equities and direct investments by Canadians abroad, including retained earnings, amounted to $688 bn since Q4 2008. That compares to a net addition of only $353 billion in fixed income assets like bonds, money market paper, loans and deposits (Chart 3 left).

What foreigners have been buying in Canada has been tilted more conservatively. While 2018 was a light year, up to that point, the bulk of the net inflow has been in fixed income assets totaling $872 bn in the last 25 quarters versus $550 bn for equities and direct investments. (Chart 3 right).

Given the climb in corporate profits as major economies recovered from the recession, Canada's tilt towards equities and direct investments in hard assets has paid off handsomely, particularly with exchange rate movements adding juice to Canadian dollar returns. Looking just at profit and dividend flows, these climbed to an annual tally of $93 bn in 2018. In contrast, foreigners' profit and dividend returns have climbed more slowly over the since 2008, and reached only $68 bn (Chart 4).

Advantage Canada. Enough of an advantage that it more than made up for the higher payments we had to make on a growing stock of debt owed to foreigners in the fixed income market relative to what Canada reaps on its debt holdings abroad. Not only have new bond issues during that period promised generally paltry yields, but through maturities, we've been retiring older paper that had higher rates and replacing it with low yield new issues. The result has been a steady reduction in the average effective interest rate paid on the pool of Canadian bonds and money market securities held abroad (Chart 5).

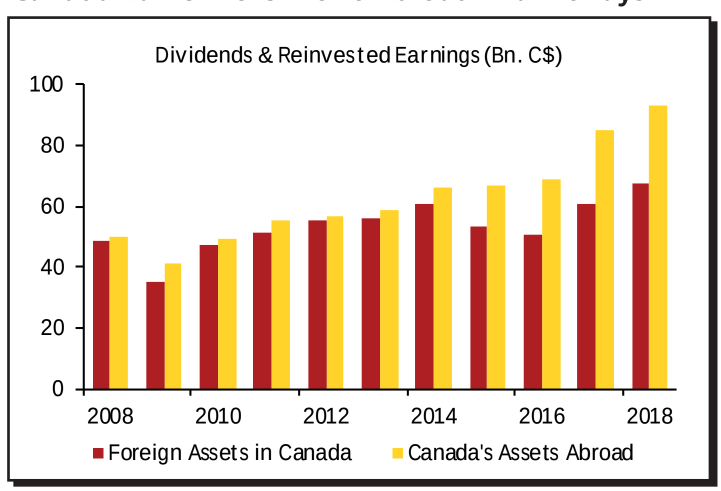
Canada's balance sheet with the rest of the world tells the same story, if measured at market rather than book value. Amazingly, even though year after year we've been a net borrower from the rest of the world, the market value of what we own abroad has climbed to exceed the market value of foreign holdings of Canadian assets (Chart 6).

What its Meant, Up 'Till Now

All of this has meant that, despite heavily financing ourselves abroad, Canadians have not dug themselves into a foreign debt hole. If we sold everything we've added to our balance sheets in assets abroad, as a country, we could clear our liabilities. Our an-

Chart 4

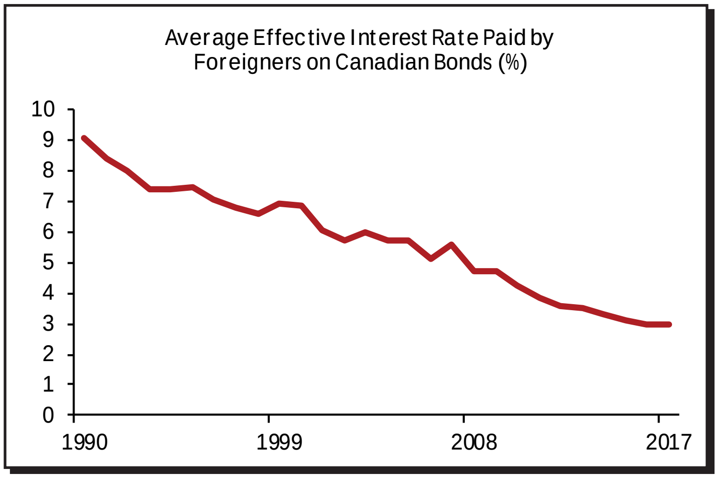
Canada Earns More Profit Abroad Than It Pays



Source: Statistics Canada, CIBC

Chart 5

Lower Rates on Foreign-Held Canadian Debt



Source: Statistics Canada, CIBC

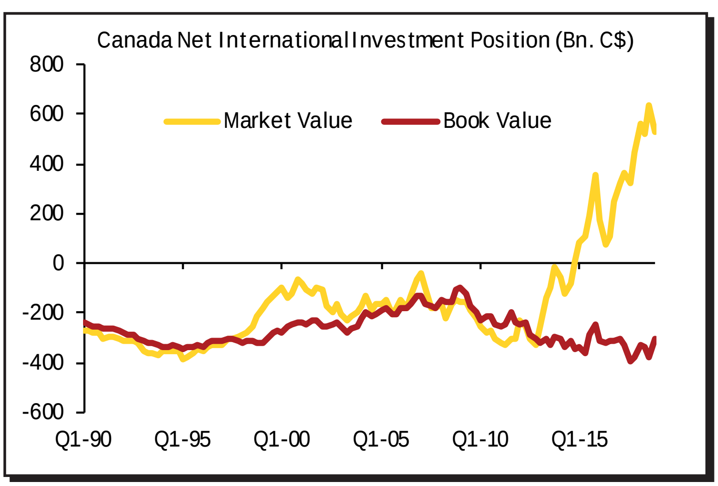
nual payments to the rest of the world are not a net burden when you take into account the profit, dividend and income flows back into Canada, which are now almost in balance.

On a flows basis, that doesn't all show up in terms of the net bid for Canadian dollars. These profit flows include retained earnings, which then show up in financial flows as an investment abroad. It's as if the Canadian owners of a foreign company convert the profits back into loonies only to immediately convert them back into the foreign currency to keep them in the company.

But it does suggest that the differences in cross border portfolio allocations, and therefore in rates of return, have prevented our steady accumulation of foreign liabilities from turning into an immediate drag on the exchange rate. The C$ can hold its ground better than it would have otherwise since repatriated profits and dividends are a healthy source of loonie demand to counter the selling of Canadian dollars by foreigners getting interest payments on our debt.

Chart 6

Canada Not a Net Debtor in Market Value Terms



Source: Statistics Canada, CIBC

The Not So Good News

We promised our readers a good news story about Canada. But we wouldn't live up to the reputation of economics as the "dismal science" if we failed to mention two not-so-good features of our international capital position.

First, Canadians have effectively been adding leverage. If you treat the entire country as one single borrower and investor, we've been adding liabilities that are mostly of the fixed payment nature to buy assets whose returns will vary more with the business cycle. In the next downturn, we'll still have interest payments to make on Canadian debt held abroad, and both the mark-to-market values and the cash flows from our equities, real estate and other hard assets abroad will slip. That said, many of these are held by pension and other funds that are in it for the long haul, and it's reasonable to expect a better return on such assets over time than the paltry yields we're paying out on bonds.

But there's one more lasting downside to the present trend. The annual net capital inflows into Canada (i.e. our net borrowing each year) are just the mirror image of a sustained current account and trade deficit. Our economy has thrived in spite of a lackluster trade performance because we've offset that with debt-financed consumption and housing.

Now that we're trying to slow the household sector's debt appetite, we'll likely need an even cheaper Canadian dollar, or a productivity miracle, to allow our trade balance to improve. We've gotten away with being a net foreign borrower without running up a net outflow on interest, dividends and profits, but we can't forever live with the associated current account and trade deficits.

Hang in there Baby: Lessons in Recession Avoidance

by Avery Shenfeld, Andrew Grantham and Royce Mendes

Business cycles come in all shapes and sizes, but last month we observed one notable and no-too-happy feature that nearly all have in common: having reached full employment, countries rarely manage the feat of hanging in there for an extended period. In both Canada and the US, for example, not since the early 1960s has the chart of the unemployment rate featured a wide flat bottom.

Looking at their own histories, and across a broader range of countries, are there lessons that Canadian and US policymakers and investors should be learning about what it takes for a country to remain in the vicinity of full employment, rather than soon getting tipped into recessionary conditions?

For Canada, the greatest threat is always a US economic downturn. America's current expansion is only just approaching its 1990's cycle in length and started from a deeper trough that left more elbow room before running out of spare labour capacity. Moreover, some cycles in countries like Australia, the Netherlands and Ireland were at least twice as long historically (Chart 1).

But that's not really the right starting point. We know that, at least in the eyes of the central banks, both the US and Canada are now close to if not already at full employment. So a better measure is to look at how long countries are typically able to hover in that range before the jobless rate shoots higher.

And there the answer isn't promising. We've identified only two cases, in the UK and Ireland, in which having reached a cycle low in unemployment, a country was able to keeps its quarterly average unemployment rate within a third of a standard deviation (in North America, about 0.5% points) of its best quarter (Chart 2). In most of the others, a recession sent unemployment sharply higher.

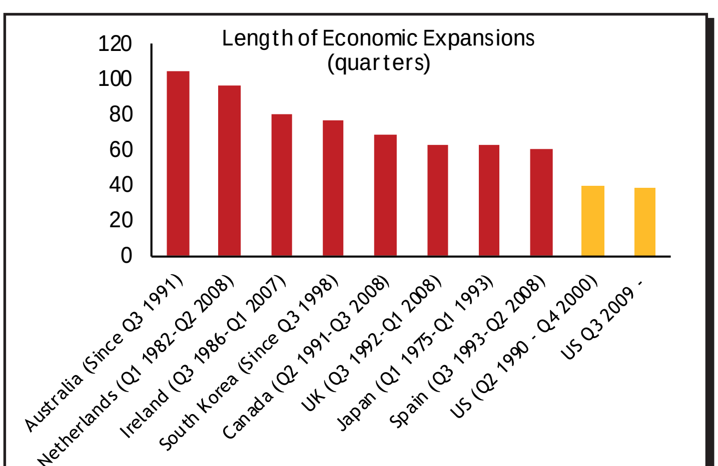
Ireland and UK: Pyrrhic Victories

Even less encouraging, the two countries that did manage a long run near full employment ended up scoring only a pyrrhic victory over global business cycle forces. Both Ireland and the UK essentially skipped the 2001 recession, but in so doing left instabilities that made the next downturn much more severe.

In keeping interest rates and banking regulations loose enough to keep their economies in gear through a global slowdown, the UK and Ireland encouraged a sharp buildup in household debt levels, relative to what was seen stateside in the same period (Chart 3 left). When the 2007/08 global crisis hit, their economies were more deeply impacted by the weakening in financial

Chart 1

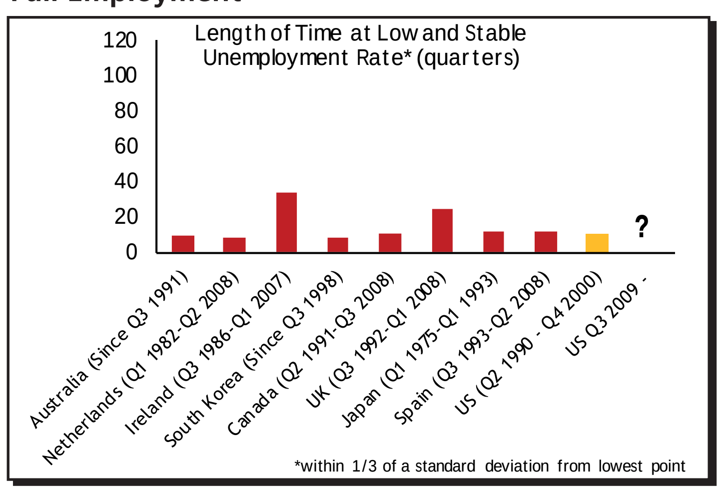
Plenty of Examples of Long Periods Without a Recession



Source: OECD, Austrade, CIBC

Chart 2

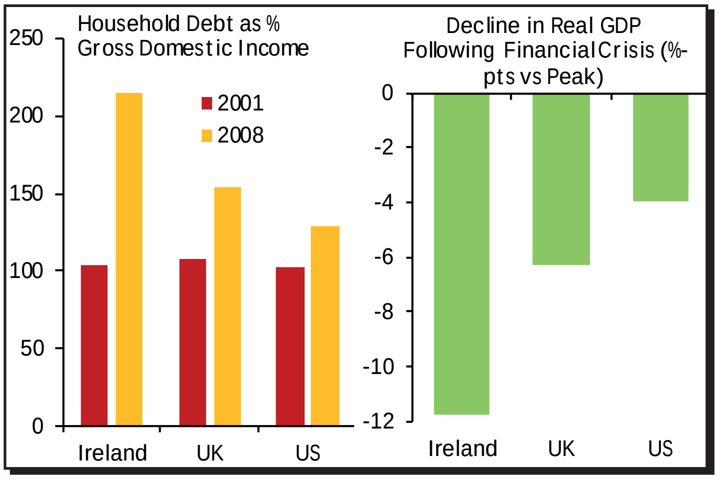
But Few Examples of Being Able to Stay Close to Full Employment



Source: Bloomberg, CIBC

Chart 3

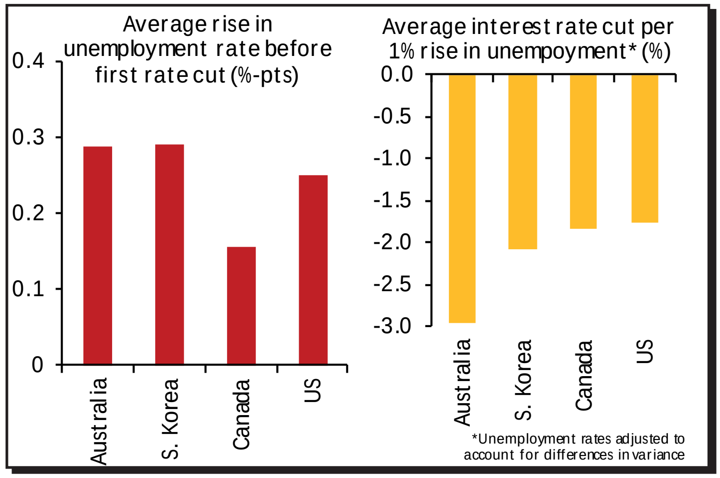
UK/Ireland Let HH Debt Climb (L) Recession Was Deeper When It Came (R)



Source: OECD, Bloomberg, CIBC

Chart 5

Monetary Policy Response Not Earlier (L), But Greater in Australia (R)



Source: Bloomberg, CIBC

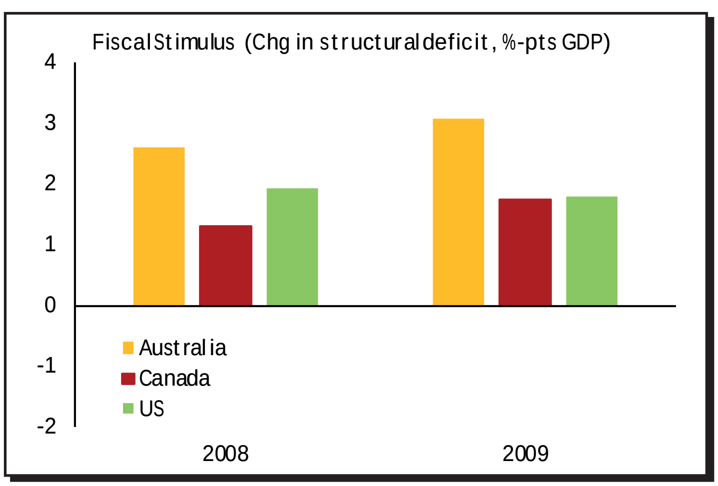
institutions, housing and related troubles, leaving both suffering from a deeper dive in real GDP (Chart 3, right).

But there was a happier outcome for a country that followed a somewhat different course, even though it ended up having a couple of close shaves with recession. Australia didn't quite meet our definition for a long flat bottom in its jobless rate, but the climbs it did experience were milder and more easily reversed. As a result, it managed to achieve a 100 quarter expansion, dating all the way back to 1991, without being defined as being in recession.

At least the last half of that period saw this antipodal country benefit from its regional links to demand from an emerging Chinese powerhouse, and its lesser ties

Chart 4

Australia Has Been Aggressive With Fiscal Policy



Source: IMF, CIBC

to financially shocked US and European markets. But perhaps a smaller part of the answer was in its willingness to use fiscal policy more aggressively than we saw in North America in 2008/09 (Chart 4), rather than only lever up its household sector.

It also has been generally more aggressive than others in deploying deeper (but not earlier) interest rate cuts in response to a given climb in the jobless rate (Chart 5). That does raise the question over whether it will, like the UK and Ireland, see some downside from that aggressiveness when it ultimately does fall victim to recession.

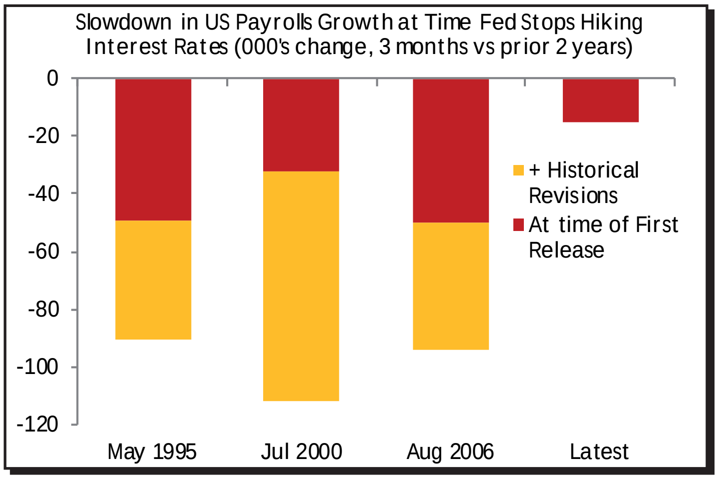
Lessons for the US and Canada

All of this brings us to where we stand today. Both the US and Canada are within shouting distance of full employment, markets are starting to wonder about their ability to hang in there, and guessing that rate cuts might be needed to avoid the worst.

Central banks seem to have learned some of the lessons we've drawn from past cycles. The Fed, for example, has at least temporarily puts its tightening plans on ice, after seeing less than a 20K per month slowdown in payrolls growth in the past three months. Other tightening cycles only came to an end after a two to three times greater hiring slowdown as reported at the time, although it turned out, that revised data show the Fed actually had only eased off after average payrolls gains had dropped off by roughly 100K (Chart 6). It has also been taking a more gradualist approach to rate hikes to give it time to

Chart 6

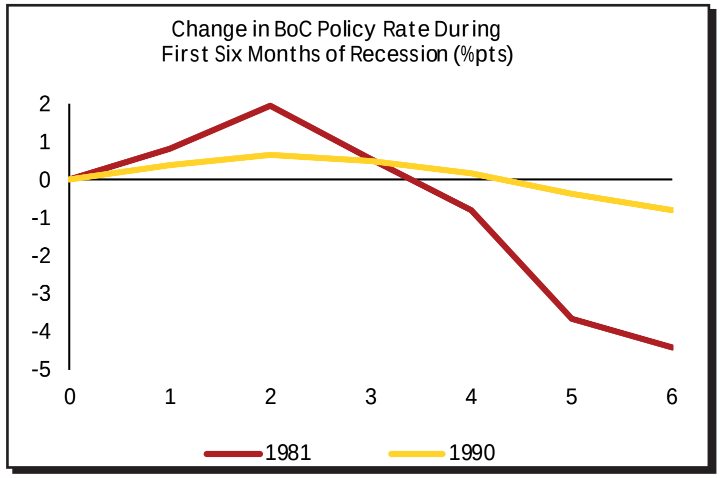
Fed Has Stopped Hiking Earlier Relative to Slowdown in Payrolls



Source: BLS, CIBC

Chart 8

Bank of Canada Was Still Hiking As 1981 and 1991 Recessions Hit



Source: Statistics Canada, CIBC

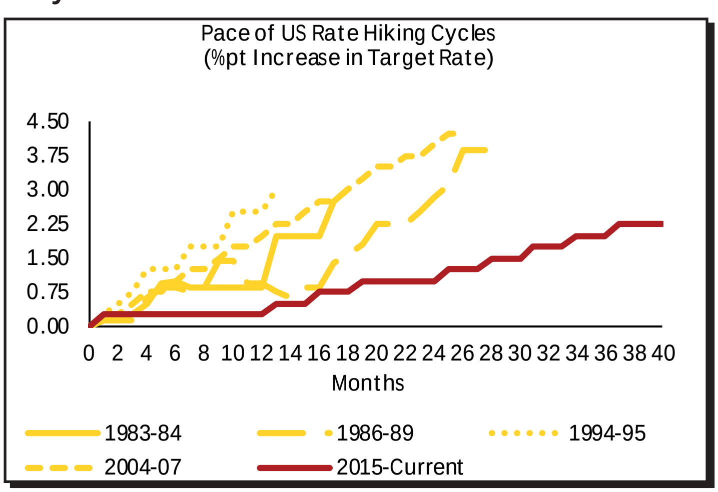
observe the impact of earlier hikes before piling on more (Chart 7).

Canada's central bank eased on a timely basis as the last global downturn began. But it missed the turning points in the recessions of the early 1980s and 90s, with rate hikes continuing after what turned out to be the onset of recession (Chart 8).

This time around, Governor Poloz seems to have backed away from hiking before we've seen the jobless rate even slightly dented. Although we have left in place the recent regulatory changes that slowed the housing market, backing away from additional rate hikes could actually reduce the odds that the rate cuts the market has been looking for will actually prove necessary.

Chart 7

Easy Does It For Fed Hikes This Time



Source: IMF, CIBC

But looking at the UK and Ireland experience also suggests that pushing hard on monetary stimulus without adequate regulatory restraints on the financial system, can be a form of recession avoidance that a country could subsequently regret.

Economists typically view monetary policy as the go-to first step when trying to counter a slowdown, given the lags in fiscal policy responses and concerns over government debts and deficits. But there's a case to be made, particularly at the Canadian federal government level, that fiscal stimulus should play a more upfront role when it becomes necessary to help Canada's economy hang in there when the next global slowdown hits.

Mortgage Stress Test: The Operation Was a Success, But...

by Benjamin Tal

You usually need to be in a recession to see household credit rising this slowly. And most of that slowing is happening in the mortgage space—not exactly surprising, given the ongoing adjustment in the housing market. The market is still in price-searching mode, and the adjustment is not over yet—especially in Vancouver and Toronto. How much of this slowing is due to the gravitational forces of unaffordable markets? Or higher interest rates? Or the impact of the mortgage stress test (B-20)? Of course, there's no way to fully disaggregate those forces. But more than a year after the introduction of B-20, we are in a position to say more about the impact of that change on the trajectory of the market in general, and alternative lending in particular.

CMHC's Interest Free Loans—Not Big Enough to Make a Difference

First let's get one thing out of the way: yes, home prices in Canada are falling, but many markets remain out of reach to many potential first-time homebuyers. The recent federal budget allocated $1.25 billion over 3 years to try to help here, by providing mid-to low-income first-time homebuyers interest-free loans of up to 10% of the property value towards a down-payment. But as illustrated in Chart 1, this program is simply too small to make a significant difference. We estimate that, fully utilized, this plan will impact only 3% of borrowers and 0.12% of mortgage origination dollars—not quite a game changer.

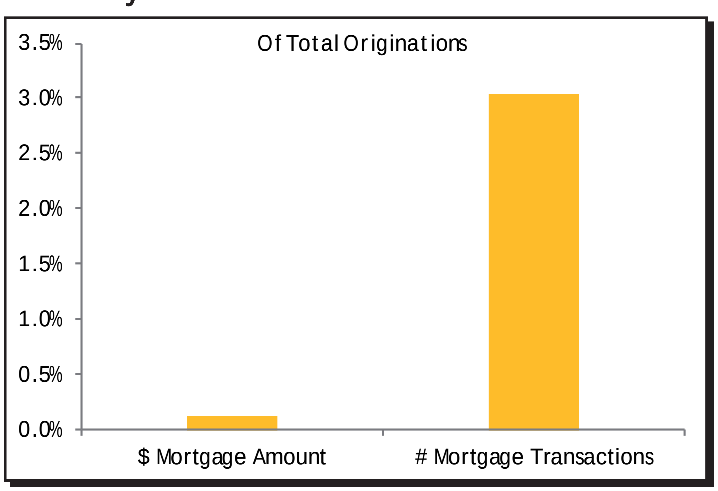
Growth in Mortgage Originations in Negative Territory

The mortgage stress test took effect in January 2018. The qualifying rate on non-insured five-year fixed-rate mortgages was raised by at least 200 basis points. In today's market you can get a five-year fixed rate of 3.5%, but you must be qualified at 5.5%. What impact did that have on the market? Let's begin with originations. During 2018, growth in mortgage originations continued to decline (Chart 2). The value of new mortgages fell by 8% (or $25 billion) during the year. Note, however, that the slowing in the pace of mortgage origination growth started well before B-20 was introduced. In fact, originations hardly grew at all during 2017. So, B-20 was imposed on a market that was already on a slowing trajectory.

Now, B-20 can impact borrowers in two ways. If you don't qualify under the new provision, you can simply exit the home-buying space, or you can settle by

Chart 1

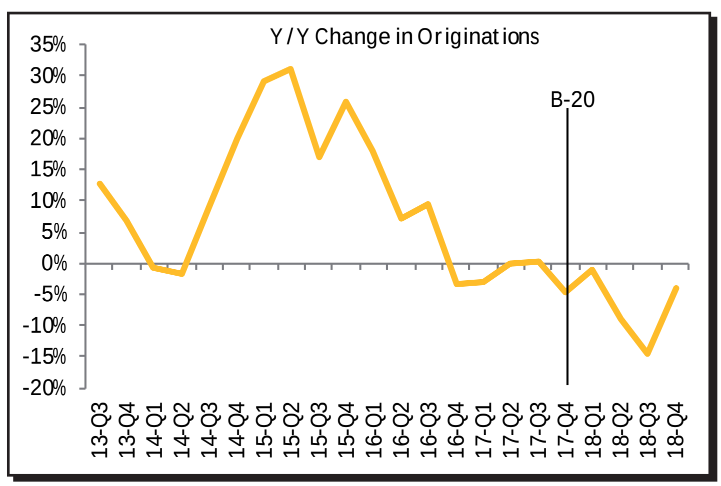
Scale of CMHC's First-Time Homebuyers Incentive Relatively Small



Source: Equifax, CIBC

Chart 2

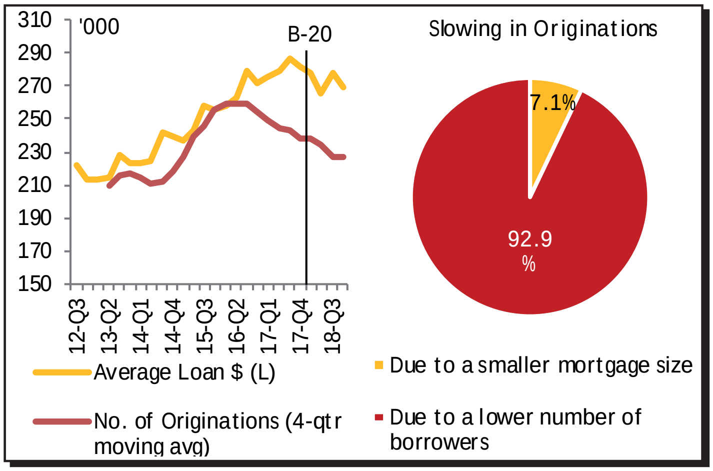
Mortgage Originations Started to Soften Well Before B-20



Source: Equifax, CIBC

Chart 3

Fall in Number of Borrowers Mostly Behind Softening Originations



Source: Equifax, CIBC

compromising and buying a smaller or cheaper house, accompanied by a smaller mortgage. Chart 3 suggests that the vast majority of the decline in mortgage originations in 2018 was due to fewer borrowers (down by 4.9%), as opposed to a smaller average mortgage. Overall, based on various sources[1], we estimate that B-20 accounted for 50%-60% (or $13-$15 billion) of the overall decline in originations throughout 2018.

B-20 is Working as Planned

There is little doubt that the architects of B-20 had Vancouver and Toronto in mind when they designed the new rule. The more stretched you are, the more likely you are to fail the test. And from Chart 4, we learn that this is exactly what took place. The damage to the housing market was directly linked to unaffordability.

B-20 was also designed to improve the overall credit quality in the market. And indeed, the share of high-quality mortgages (i.e. credit score >751) in originations is currently at a record-high of more than 52%. Note, however, that this trend of quality improvement was in place well before B-20 was introduced. The 21 policy changes related to residential mortgage lending introduced by governments and regulators over the past decade played a significant role in improving overall credit quality in the Canadian market. The point being that, B-20 was introduced to an already healthy credit market.

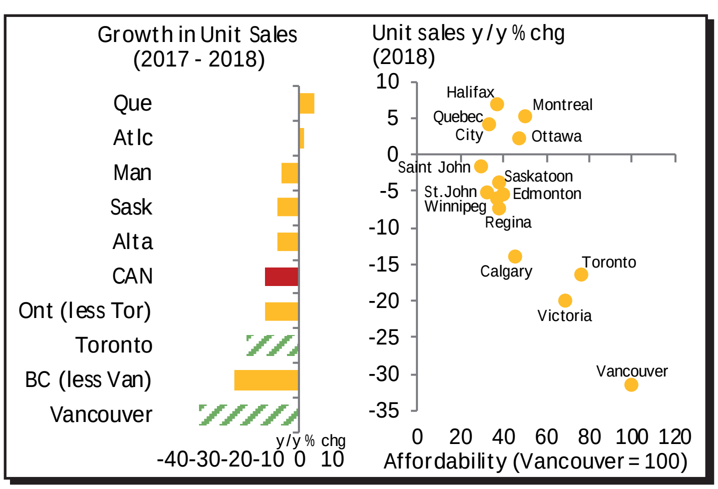
Shedding Light on Shadow Banking

The improvement in credit quality is obviously a good thing. But, is that the full picture? The mortgage credit score information—obtained from Equifax—covers roughly 85% of the market. However, what is not captured in the data is the credit score of borrowers that don't use traditional lenders. So, to the extent that more borrowers use alternative channels, due to policy changes in general, and B-20 in particular, the market might be riskier than perceived. Let's take a look.

Using information obtained from the Ontario Land Registry, alternative lenders account for close to 12% of the total number of transactions (about 15% for the GTA). A year ago, that number was close to 10%, meaning that alternative lenders' share has risen since the introduction of B-20 (Chart 5). But, what's interesting is that the upward trajectory was established in 2017 when

Chart 4

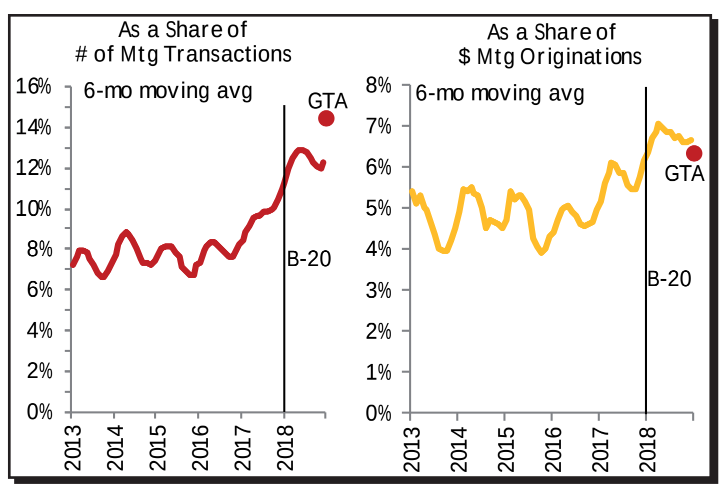
B-20 - Most Effective In Less Affordable Markets



Source: CREA, Statistics Canada, CMHC, CIBC

Chart 5

Alternative Lenders



Source: Teranet, CIBC

alternative lenders accounted for only 8% of new loans. Over the past two years, mortgage originations provided by alternative lenders rose by a cumulative 27% while originations in the market as a whole fell by 11%. Beyond B-20, that might reflect the impact of the stress test that was imposed on high-ratio mortgages in late-2016 as well as regulatory-related credit restrictions on new immigrants and those self-employed.

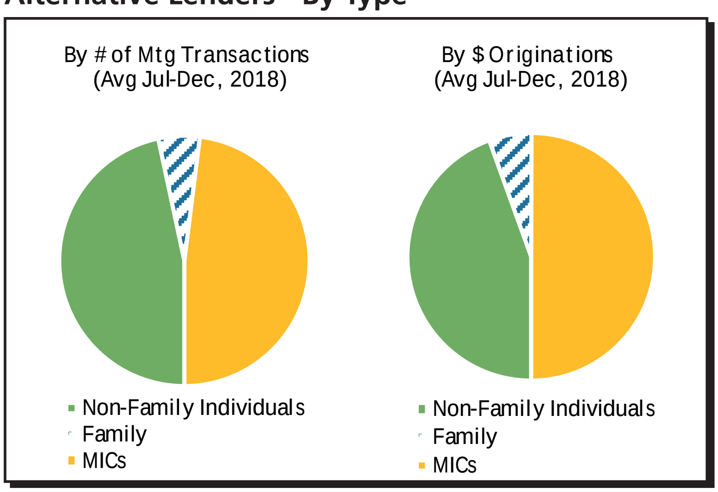
When we calculate the share of alternative lenders in the value of dollar originations, they account for close to 7% of the market—up from 5% in the pre-2017 period. The share of alternative lenders in dollar originations is lower than their share in the number of transactions because their average loan size is roughly half the size provided by banks.

While we are on the subject of alternative lending, let's use this opportunity to dig deeper into the segmentation of that market. Chart 6 presents information pertaining to the composition of those alternative lenders: individual lenders account for just over 50% of all alternative lenders, while institutional lenders—mostly Mortgage Investment Corporations (or MICs)—account for the rest[2]. Also note that we estimate that only 10% of individual lenders in that space consist of family-related loans[3]. In terms of their trajectory, both segments of the alternative lending space witnessed strong increases in activity since 2017, with the average loan size provided by individual lenders rising more quickly, as shown by the dollar-value gain in their market share.

Alternative lending is an integral part of any normally-functioning market. But a fast-growing alternative lending market is not. Behind the scenes, there is a transfer of risk from the regulated to the less regulated segment of the market—from where there is light to where it's dark. That was certainly not the intent of B-20, and any other mortgage-related change to regulations.

Chart 6

Alternative Lenders - By Type



Source: Teranet, CIBC

Now, we must put this into perspective. Zooming in first on MICs, given that MICs focus mostly on short-term loans (median being one year vs. five years for banks) that potentially can be moved elsewhere, the impact on overall mortgage outstanding is limited. Furthermore, limited funding sources put a cap on their ability to aggressively continue to gain market share. That's not the case for private lenders. Their funding model does not require short-term credit, they are free from any regulations, and can potentially continue to gain market share. Accounting for more than 50% of the alternative lending space, this segment of the market is where the regulators' focus should lie.

Time to Rethink B-20?

The stress test imposed on the market was probably necessary, since there was a need to save some Canadian borrowers from themselves. But is 200 basis points the right number? At the end of the day, there is no real science behind that number. Let's remember that the rule was introduced in an environment of an already slowing market, and that since then, the Bank of Canada has hiked rates by 75 basis points, and the five-year mortgage rate has risen by 35 basis points.

Furthermore, borrowers' income is likely to rise during the mortgage terms. Average personal income has risen by a cumulative 12.5% over the past five years—the stress test does not take that into account. Nor does B-20 allow for the fact that during the course of the mortgage term, equity position rises due to principal payments. Another shortcoming is that the stress test doesn't consider mortgage term and the decreasing borrower risk with longer terms selected. And finally, B-20 is in part behind the strong rise in alternative lending.

Accordingly, regulators should revisit B-20. We need a more flexible benchmark, potentially a narrower spread over the contract rate when interest rates approach cyclical peak, and perhaps to establish a reasonable floor under which the qualifying rate will never drop below.

Note

1. *Sources: CIBC, Equifax, MPC.*
2. *Since MICs dominate this group, from this point forward we refer to it as MICs.*
3. *This was done by matching the names of lenders and borrowers.*

ECONOMIC UPDATE

CANADA	**18Q4A**	**19Q1F**	**19Q2F**	**19Q3F**	**19Q4F**	**20Q1F**	**20Q2F**	**2018A**	**2019F**	**2020F**
Real GDP Growth (AR)	0.4	1.3	2.5	2.0	1.7	1.1	1.5	1.8	1.6	1.5
Real Final Domestic Demand (AR)	-1.5	2.1	2.1	1.9	1.5	1.4	1.6	1.9	1.0	1.6
Household Consumption (AR)	0.7	1.4	2.3	2.1	1.5	1.4	1.6	2.1	1.5	1.6
All Items CPI Inflation (Y/Y)	2.0	1.6	2.0	1.9	2.3	2.5	1.9	2.3	1.9	2.2
Unemployment Rate (%)	5.7	5.8	5.8	6.0	6.1	6.1	6.1	5.8	5.9	6.2

U.S.	**18Q4A**	**19Q1F**	**19Q2F**	**19Q3F**	**19Q4F**	**20Q1F**	**20Q2F**	**2018A**	**2019F**	**2020F**
Real GDP Growth (AR)	2.2	1.4	2.3	2.1	1.4	1.1	0.9	2.9	2.2	1.5
Real Final Sales (AR)	2.1	1.4	2.5	2.4	1.2	1.3	1.3	2.7	2.1	1.6
All Items CPI Inflation (Y/Y)	2.2	1.6	1.6	1.8	2.3	2.7	2.4	2.4	1.9	2.3
Core CPI Inflation (Y/Y)	2.2	2.1	2.3	2.4	2.4	2.4	2.3	2.1	2.3	2.2
Unemployment Rate (%)	3.8	3.9	3.8	3.8	3.8	3.9	4.1	3.9	3.8	4.1

CANADA

After a rough final quarter of 2018, the economy finally received some good news by way of January's above-consensus GDP reading. That sets up Q1 for a rebound in growth to a bit below 1 ½%. While headline inflation has also accelerated back up to the Bank of Canada's target, it has been mostly the result of higher gasoline prices. The central bank's three core measures, combined with easing capacity pressures in the Bank of Canada's outlook survey, suggest that underlying inflationary trends remain under control.

UNITED STATES

The US economy likely shifted into a lower gear in Q1, expanding by a modest 1.4%. Indeed, the government shutdown worked to delay household spending, adding to the impact of higher interest rates which have also started to cool business investment. Although consumer spending is poised to rebound in Q2, helped by rising wages and a sizeable savings cushion, higher interest rates and an economy that is approaching full employment will limit growth thereafter, reinforcing the Fed's cautious stance.