CAPSTONE
ASSET MANAGEMENT™

THE HOUSING MARKET AND ITS IMPACT ON OUR MORTGAGE POOL

June 2017

With the news of inflated prices in the downtown Toronto core continuing to make headlines alongside the risk for an eventual increase in interest rates, we are often asked about the implications for our Mortgage Pools. Because of the growing concerns fueled by the media, we'd like to take this opportunity to share some insight into Capstone's current approach and thinking.

There are a number of different aspects in the market that we monitor to help us determine the ongoing risks in the real estate markets. They include the following:

UNEMPLOYMENT is a key measure we watch as it is suggested most people buy the concept of a mortgage payment rather than a house price. While unemployment remains low there is little pressure on their household financial picture. By monitoring the unemployment rates, we can determine if pressure may be building in the housing mortgage market overall. Although this doesn't directly impact the mortgages in our pools, as they are not traditional residential term debt mortgages, it would have a knock on impact on our industry. Currently, Ontario's employment picture is strong and we don't perceive pressure building in this area. At this time, we qualify this as a low risk.

HOUSING AFFORDABILITY is also an important factor. This is one area where in the city of Toronto itself we see increasing risk around affordability. In the regions that we focus on, call it the commuter belt, the affordability, although being stretched, is in a far better position than downtown, and pales in comparison to the suburbs of Vancouver which are substantially worse. At this time, we qualify this as a moderate risk, but increasing.

INTEREST RATES are obviously something to keep an eye on and currently the Central Bank appears to be holding steady on its rates. Although the US will likely raise rates, there is still evidence of a headwind due to the interest burden which may limit the moves in the bond market. There may be a move in the mortgage rates in Canada, but at this point there is little evidence to suggest a significant risk of a large move. At this time, we qualify this as a moderate risk.

POLICY INTERVENTION is another key area we monitor, but the moves being made appear cautious as the governments desire a pricing slowdown, not a collapse of the market. Having said that, the intervention we have seen so far may have limited impact on the current environment, with some policies potentially increasing demand. At this point we don't see the decisions significantly increasing risk. Anecdotal evidence in Vancouver has demonstrated that the foreign ownership tax had an initial impact on the market, but sales are again picking up steam in some of the areas where the tax was implemented. At this time, we qualify this as a moderate risk.

INVENTORY LEVELS of housing is another key supply side driver that we monitor to better understand the nature of the demand that we see in the market. Currently, inventory levels appear to be low in certain sectors providing an indication that the demand for these property types is due to undersupply in the marketplace. At this time, we qualify this as a low risk.

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CONTAGION – currently this is the 'Home Capital' risk, where issues completely unrelated to the quality of the underlying mortgage investments can potentially cause irreparable damage to a business. The risk of contagion becomes elevated when the factors contributing to this situation are misunderstood and therefore are overlaid onto other similar organizations. Currently this situation appears to be contained to Home Capital as other industry participants have stabilized after the initial market reaction. One thing we are monitoring is the HISA (High Interest Savings Account) market where the potential mismatch between daily liquidity and the underlying product may put pressure on some of these other businesses to either limit or stop this business. This would extract potential capital flows into the market which we believe could have a negative impact if not replaced, but at this point there is no evidence of this occurring. At this time, we qualify this as a moderate risk.

There are additional factors we monitor that are specific to our portfolios. This includes things such as portfolio concentration risk to one project, developer, sector, geographic region of Ontario, average term to maturity, average loan to value, any pressure we see building in projects and if so how many, the number of projects running into difficulty and whether that is going up or down etc. As always, there are some projects with pressure, but this is still all within the levels of normality for the sector. The underwriting criteria remains rigorous with both MarshallZehr and Capstone performing their own individual due diligence prior to Capstone making any investment decisions.

There is definitely an unsustainable rate of price increase year over year in the Toronto market and the affordability of housing in downtown Toronto is stretched by Ontario standards, but that doesn't mean that the market will collapse. Rather, we could see a reduction in growth, a period of flat markets or even a normalized decrease. However, one thing we often hear is a comparison of Toronto/Vancouver to the US housing meltdown. In our opinion that is not an accurate comparison as the leverage we saw built structurally into the US system does not exist in the same way in Canada. Many of the mortgages in Canada are insured, the average LTV of mortgages at the big banks is typically lower than in the US pre-crisis, and the sub-prime space in Canada is comparatively small. If the market does turn, the chance of a US style meltdown in our opinion is low and without the same leverage structure would look different here. So, although Capstone would agree that the downtown Toronto Market has high risk aspects such as rate of price increases and affordability, we believe there needs to be additional changes in the above factors to negatively impact that particular market. Our funds are currently invested outside the downtown core and into markets where we do not see the same types of risk.

Finally, the structure of our Pooled Funds is such that clients' funds are pooled together to fund a number of projects (as opposed to lending money to a single project) which creates diversification and reduces risk. Additionally, our Mortgage Pool adds what we consider to be an even stronger protection as the Mortgage Administrator and the Portfolio Manager are two independent firms conducting their own due diligence. To be sure, our Mortgage Pools are not a guaranteed product nor are they risk-free, but it is the combination of our macro views of the housing market taken together with a thorough analysis of each project that shape our investments within the Fund. Ultimately, we still believe that this is an excellent opportunity presenting a strong risk-adjusted return within a well balanced portfolio.

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