JKDCAPITAL

Canadian Housing: On The Ropes

REAL ESTATE

Vancouver parents buy property for young children to secure a future foothold

Buyers investing in properties for their children as hedge against unaffordable future

By Jen St. Denis | June 6, 2016, 10:23 a.m.

September 20, 2016

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Dear Investor:

Since the Fund's inception we have maintained that while timing the collapse of credit and housing bubbles is impossible, credit bubbles do exhibit certain characteristics en route to their ultimate demise, and that these signposts would guide our capital allocation decisions. Our primary concern was first and foremost to preserve capital in the face of negative carrying costs while the bubble inflated, and to strategically deploy capital as events confirming the timing of our thesis came to pass.

Ominous signs began to appear during the summer of 2015 and accelerated to the point that nearly every signpost that we have been waiting for has occurred:

- signs of a manic blow-off top in Canadian housing, including unsustainable and downright jaw-dropping house price increases in Vancouver and Toronto, parents buying property for toddlers to "secure a foothold in the housing market", and the new normalcy of "covenant-lite" home sales without an inspection;
- extremes in Canadian housing unaffordability, leverage and systemic risks;
- fissures forming in speculative psychology in Alberta, Vancouver, and amongst Chinese buyers;
- the revelation of pervasive fraud across wide swaths of the Canadian financial landscape;
- lax mortgage underwriting that makes some of the US credit excesses of 2005-2006 seem tame in

comparison;
- "extend and pretend" policies to maintain the illusion of low delinquencies in the face of mounting financial stress;
- notable failures within the MICs (mortgage investment corporations) as well as real estate developer sectors;
- record-setting real estate construction in response to inflated prices;
- a populist uprising against Canadian housing unaffordability and foreign money laundering/influence buying;
- significant governmental tax and regulatory interventions into the housing markets;
- increasing regulatory risk for the Canadian banking system as provisions for bad debt and capital adequacy ratios rank among the weakest of any major country in the world;
- the continuing hollowing out of the Canadian economy as it becomes dominated by credit flows and housing-related activity;
- an oil shock that decimated one of the few productive non-housing/financial pillars of the Canadian economy and the Albertan provincial economy;
- an increasingly unhealthy Chinese economy, combined with a resolute crack down on capital flight resulting in decelerating Chinese housing demand abroad; and
- an increasingly risky global macro and geo-political backdrop.

Therefore, while we remain mindful of and strive to mitigate the Fund's carrying costs, we are now aggressively deploying capital as we think the end is in sight for Canada's credit and housing bubble. We are frequently asked--what will cause the bubble to burst and when? How can the bubble possibly burst without some sort of external shock such as a spike in interest rates and/or unemployment? As Pater Tenebrarum explained:

> *Bubbles don't burst because of a "black swan" [a supposedly unpredictable event]: rather the swan – often a combination of events that makes it impossible to identify a single trigger – is a diffuse trigger mechanism that sets into motion what is already preordained. It is the famous "one grain too many" that is put atop a giant sand pile – however, it is the sand pile that is the problem, not the one grain. This is also why precise timing of a bubble's demise is so difficult – it is unknowable what exactly will actually lead to the change in perceptions that ultimately provokes the unwinding of the leverage that has been built up.*

We are able to foresee any number of triggers that could burst the bubble (several of them already in play), but we are particularly focused on anything that causes a tightening of credit conditions (e.g., as a result of government regulations, risk-sharing on mortgage insurance, losses suffered in Alberta, changing speculative/lending psychology, a major fraud collapsing, etc.). Current events in Australia foreshadow how such a credit squeeze could occur virtually overnight in Canada, as funding for all Australian deals involving foreigners have "been frozen and [buyers] face foreclosure - or usurious interest rates - from private financiers…Lenders [who] initially fell over themselves to finance overseas' buyers, slammed on the brakes when spot checks on the loan applications detected widespread fraud."

To specifically address the employment/interest rate question, I will note that we housing bears had the identical debate with bulls back in 2006 in the US:

TUESDAY, JUN 13, 2006 9:12 PM UTC

The man behind the Housing Bubble Blog

Harvard says: No housing crash. The Internet disagrees.

ANDREW LEONARD Follow

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Last week, Harvard University's Joint Center for Housing Studies released a comprehensive report on the U.S. housing market. Although it made some nods to the sorry — and worsening — state of affordable housing, overall, the report was bullish. There's been some softness in the market of late, it noted, but fundamentals are strong, and the next decade should see a renewed boom.

The money quote: "The most immediate risks to the housing market now come from the rise in interest rates, the erosion of affordability after years of strong house price appreciation, and the growing inventory of both new and existing homes for sale. But unless the broader economy stumbles and job losses mount, home sales and construction activity will likely dip only modestly."

At the Housing Bubble Blog, run by Ben Jones, readers were quick to point out a possible flaw in the Harvard analysis. What if the housing boom *itself* has been one of the main forces supporting the broader economy? Many economists have suggested that the American consumption binge of the past half-decade has been fueled by easy money extracted from housing via refinancing or home equity loans. Couldn't a slowdown in housing precipitate a wider economic downturn?

What signposts have yet to occur? Significant house price decreases, widespread retrenchment in the private/alternative lending space, and the failure of a significant financial institution. What could further prolong the bubble? Additional stimulus/quantitative easing, re-accelerating capital flight from China, a prolonged oil rally above $70, a shift in foreign flows from Vancouver to Toronto/Montreal rather than a shrinking overall flow to Canada, or a reversal of recent governmental regulatory tightening in the mortgage/housing market.

Global markets continue to ignore obvious and mounting systemic risks—particularly with regards to China and Europe; against this backdrop we expect that the precarious credit and housing situation in Canada will deteriorate further throughout 2016-2017. Your Fund is positioned to asymmetrically profit should any of these risks come to fruition. We are grateful for your continued confidence and support and we are available should you wish to discuss any aspect of our investment operation.

The appendix that follows is lengthy but we think necessary to understand the risks facing the Canadian economy in 2016-2017 and to protect your capital accordingly in advance of the bubble bursting.

Best regards,

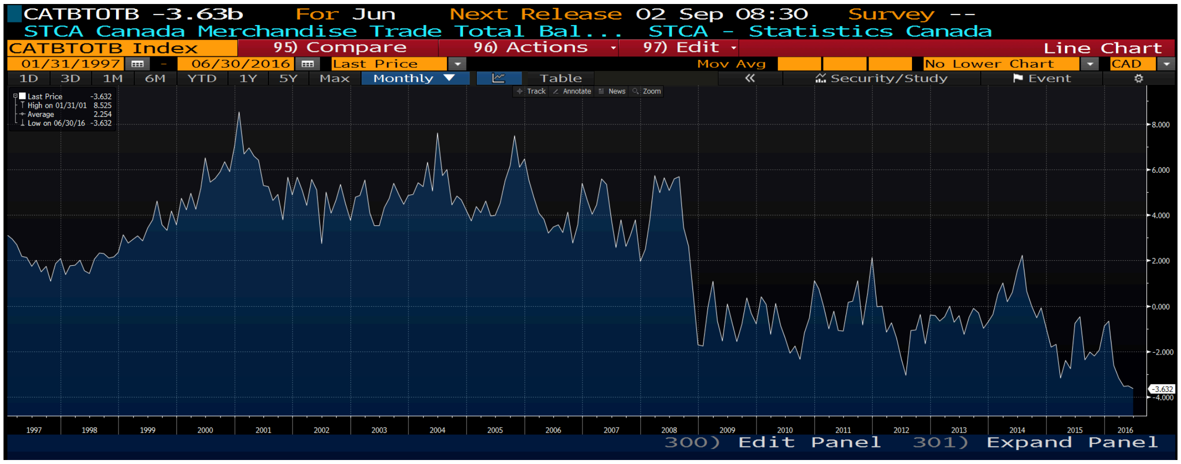
Seth Daniels

Seth Daniels
Managing Member
JKD Capital, LLC

<u>Recessionary Economy Even Pre-Housing Collapse</u>

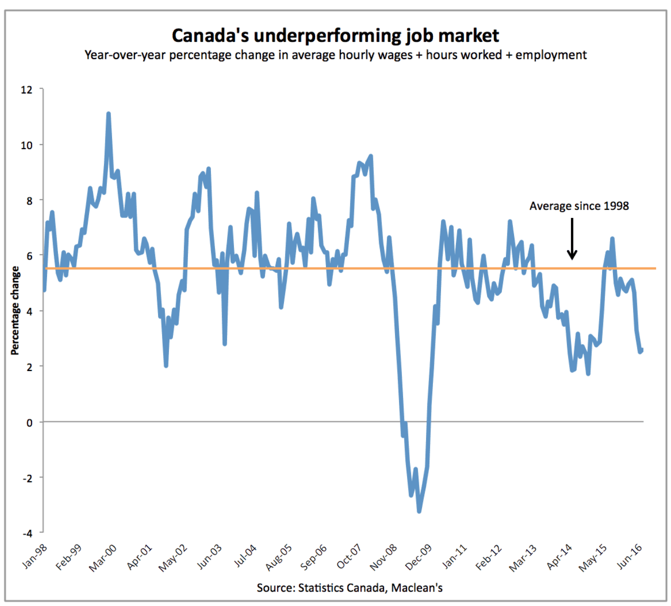
Despite record low rates, the Canadian economy likely shrank at its fastest rate since 2009, and the country is facing the largest trade deficit in its history, the weakest recovery for business investment in decades, and a Canadian private sector that is on track for its lowest share of capital expenditures in 25 years:

Canada's Record Trade Deficit



Source: Bloomberg

The Canadian economy is adding jobs at the slowest pace outside of a recession since at least the mid-1970s, despite a large increase in non-productive public sector jobs (as Canada issues the most debt in seven years):



Source: Rob Kirby/Macleans

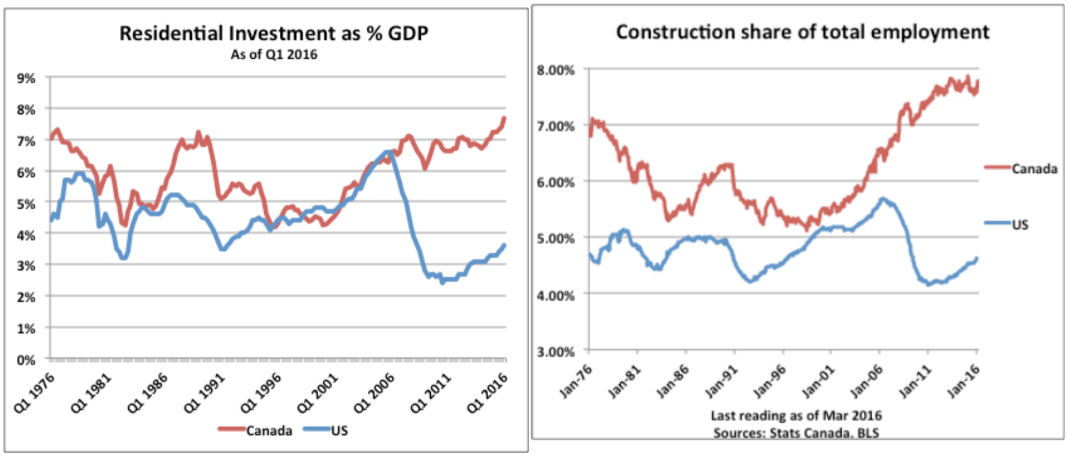
<u>The Hollowing Out Of The Canadian Economy</u>

The composition of Canadian economic performance is even more troubling than its absolute performance, highlighting Canada's continuing addiction to the twin drugs of credit and housing and a dearth of economic activity outside of financials and real estate. The scale of the Canadian housing bubble—and therefore the Canadian economy's addiction to housing—far exceeds the US at its peak:

	Canada 2015	US 2007
House Prices : Rents	190%	127%
House Prices : Incomes	16x	12.5x
House Prices : Per Capita GDP	8x	6.5x
Home Ownership Rate	70%	69%
FIRE* % GDP	20%	18%
Residential Construction % GDP	7%	6%
FIRE* % Stock Market	38% (TSX)	21% (SPX)
FIRE* % Stock Market Earnings	50%e (TSX)	30% (SPX)
FIRE+related Employment % GDP	14%	11%
Household Debt % GDP	96%	94%
Household Debt % Disposable Income	165%	128%
HELOC** % GDP	12%	4.5%
Govt. Sponsored Entities % GDP	~50% (CMHC)	~33% (FNM/FRE)

*FIRE: Financials, Insurance, & Real Estate
*HELOC: Home Equity Line of Credit

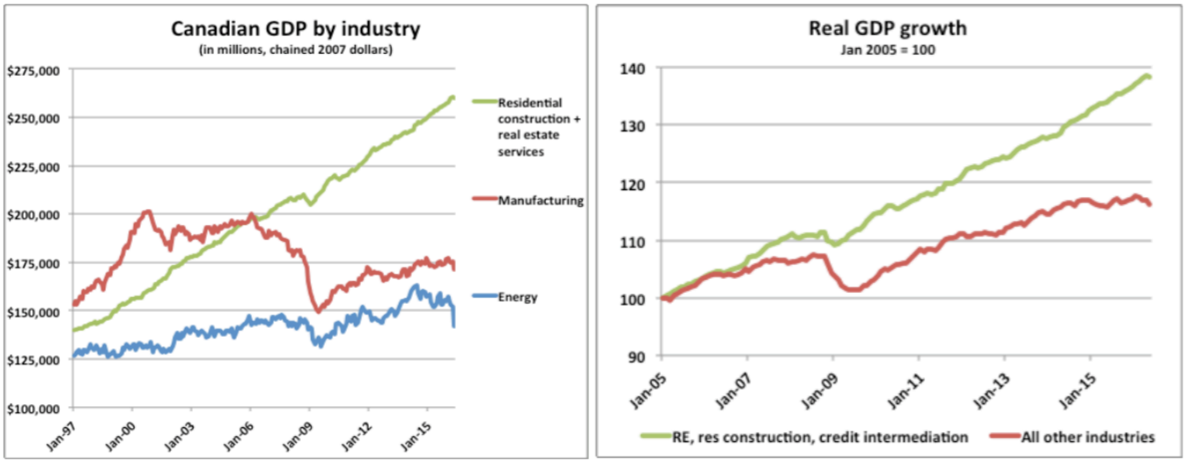
Residential investment recently reached an all-time high of nearly 8% of GDP, surpassing the 1989 peak that occurred at the top of the last Canadian housing cycle; at the same time construction's share of total employment neared a record 8%:



Source: Ben Rabidoux/North Cove Advisors

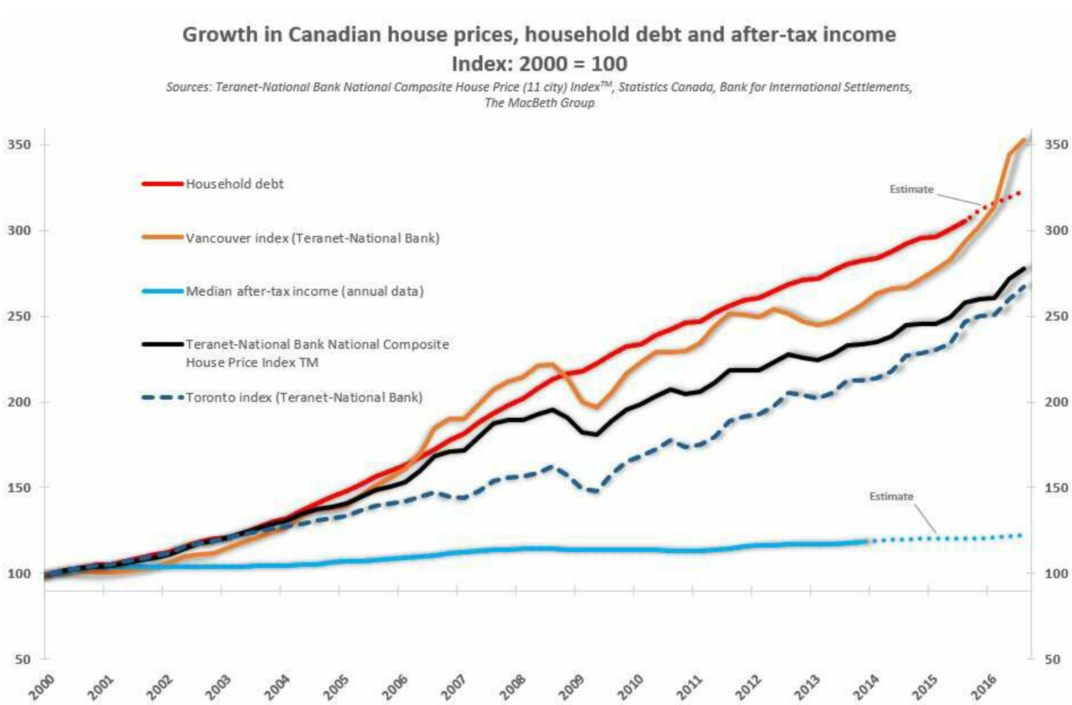
House prices in Ontario subsequently fell 25% peak-trough from 1989-1993 despite a much healthier underlying economy and 1000bps of Bank of Canada emergency rate cuts over 4 years; now even before the bubble bursts, Canada is already suffering through a weak economy and rates have been pinned at emergency levels for years. Also note in the above chart that not only has Canada residential investment as a percentage of GDP surpassed that of the US in 2006 and Canada's prior peak in 1989, but that it has remained at this elevated level for much longer than in either prior instance (for nearly 10 years running now!). This signifies that the cumulative damage to the economy from this misallocation of resources is far greater than it was in the US in 2006 or Canada in 1989.

This perfectly highlights a point that we have harped on in the past: **counterintuitively, the longer a bubble goes on, the riskier it becomes**. Canadians become increasingly inured to the bubble every year that goes by and take on additional risk because no one has apparently suffered any ill effects due to increasing indebtedness, deteriorating housing affordability, the misallocation of resources within the economy, and so on.



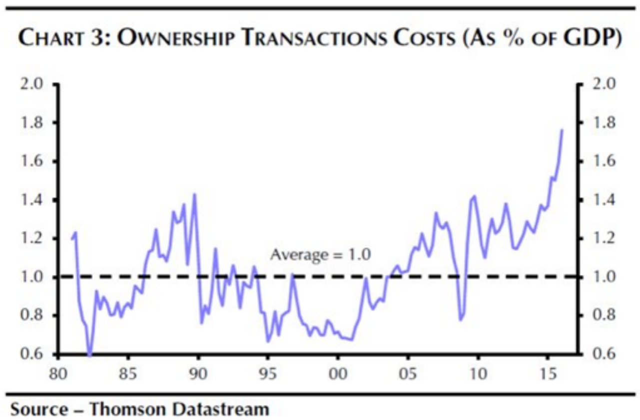
Source: Ben Rabidoux/North Cove Advisors

The problem, of course, is that the bubble is now orders of magnitude larger and exponentially riskier than when naysayers warned of the bubble 5 or 10 years ago. The analogy we frequently use is of someone who started off smoking one cigarette, then eventually progressed to one box per day. Now, several years later, that same person is consuming 20 boxes a day and laughing at the idiot doctors who were obviously wrong to warn them of the risk.



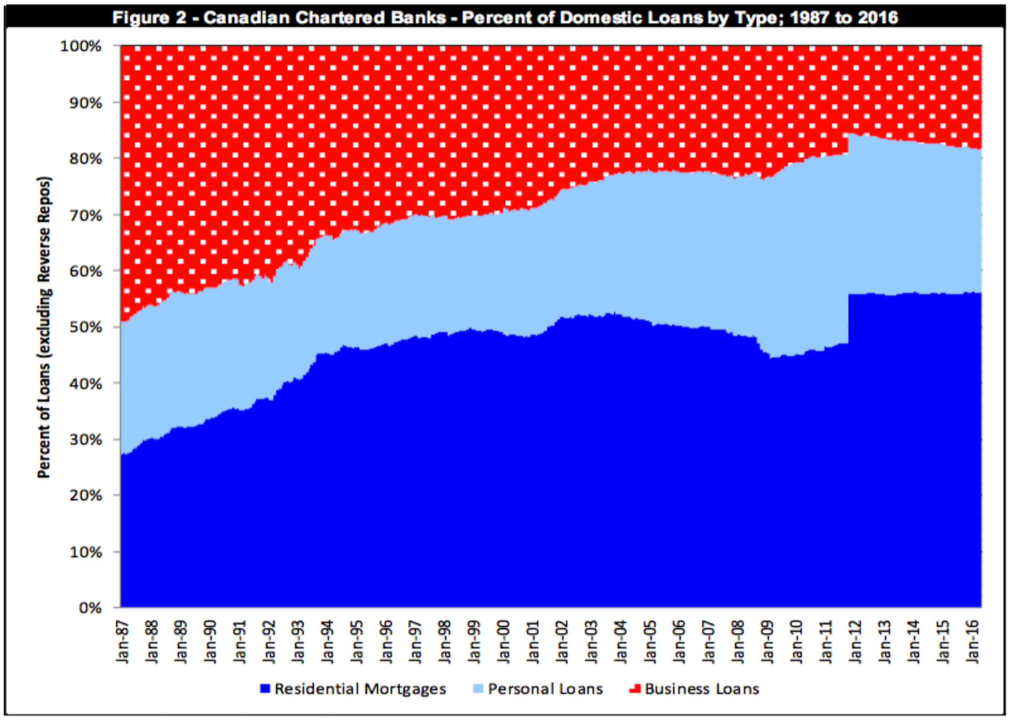
Source: The MacBeth Group/Richardson GMP

Another crude (and jaw-dropping!) gauge for the critical importance of housing to the Canadian economy is captured in the Capital Economics chart below, which shows that housing ownership transaction costs represent nearly 2% of GDP and 21% of the GDP growth post-2014 (!!!):



Source: Capital Economics

The chart below shows that the Canadian banking system has loaned to consumers at the expense of businesses, shifting capital away from the productive sector of the economy. This is an extremely unhealthy occurrence:



Source: Bank of Canada, Statistics Canada; NBF Analysis

Source: Peter Routledge/National Bank

<u>There Will Not Be A Soft Landing</u>

<u>In aggregate, all of the preceding factors imply that there is virtually zero chance that the central planners in Canada will be able to engineer a soft landing when housing rolls over.</u> Contemplate the damage incurred by the collapse of energy on the Canadian economy; natural resources in aggregate (including energy, mining, and agriculture) account for less than 9% of Canadian GDP. Real estate, finance, insurance, and construction alone account for nearly 30% of GDP—that does not include the approximately 12% of GDP in the form of HELOCs that drive consumer spending, or the nearly 20% of GDP that is public spending (including health care, education, etc.) that is itself dependent for funding to a worrying degree on the credit and housing bubble.

<u>Tightening Regulatory Environment At All Levels Of Government</u>

The Canadian public has grown increasingly discontented regarding the societal, cultural, and financial fallout from the housing bubble. A trickle of media stories earlier in the year regarding unaffordable housing, foreign money laundering, and speculation in the housing markets turned into a deluge in Q2/Q3. The Federal and Provincial governments scrambled to react to the media stories as well as new warnings from several Canadian banks, the IMF, and the OECD regarding significant risks to the housing market.

After years of ignoring (if not exacerbating!) the problem, it now appears that there is a consensus at both the Federal and Provincial governmental levels that action must be taken to confront the grave systemic risks from the credit and housing bubble:

- A FSCO (Financial Services Commission of Ontario) panel recommended in June that syndicated mortgages (pooled mortgages for real estate development projects) be placed under provincial securities regulation. Syndicated mortgages are currently barely regulated, so for example someone who has been banned for life from selling stocks can reinvent themselves as a syndicated mortgage expert selling to unsophisticated "investors" while making outlandish claims regarding the risk/reward of the mortgages.
- Prime Minister Trudeau in early June publicly stated that booming house prices hurt the economy, that he is the champion of the middle class, and that the middle class is no longer able to afford a family house.
- In late June Finance Minister Morneau created a working group on housing markets and ordered a "deep dive" into real estate fundamentals.

- The B.C. provincial government--—facing political backlash over unaffordable housing that could lead to an NDP victory in the upcoming election—formed a real estate advisory panel in response to the media exposés. The advisory panel in late June released a highly critical report regarding regulatory oversight of the real estate industry and contained 28 recommendations—<u>all</u> of which were implemented by the provincial government the <u>very next day</u>. Importantly, B.C. Premier Christy Clark declared that the real estate industry failed to self-regulate and placed it under B.C. government oversight.
- On June 22, the mayor of Vancouver announced a vacancy tax on empty houses.
- On July 1, the Canadian Mortgage and Housing Corp. (CMHC) introduced new restrictions regarding how lenders can use portfolio insurance. The changes are complicated, but the end result will likely be a strain on funding costs for banks and mortgage lenders which will in turn either lead to higher costs for mortgage borrowers, or less money to make new loans.
- On July 7, the Office of the Superintendent of Financial Institutions (OSFI) released a letter to regulated financial institutions warning them regarding residential mortgage risk management and underwriting practices. We strongly suspect that OSFI learned of some of the egregious "shenanigans" in the Canadian mortgage marketplace. Particular areas of focus identified in OSFI's letter include income verification and underwriting practices on non-conforming loans, which we believe will have a larger relative impact on smaller mortgage players than the large Canadian banks. OSFI reiterated its plan to implement strengthened capital requirements for mortgages by November 2016.

- On July 25, the B.C. government announced an additional 15% tax on residential property transfers to foreign entities in the Greater Vancouver district. This new tax will also apply to condo presales when the development completes and the buyer takes occupancy. Buyers who put 15 or 20% down in a new condo development will be facing an unexpected 15% tax when they take occupancy.
- On July 26, OSFI published a letter to deposit-taking institutions regarding capital requirements that will likely mean higher rates for many borrowers. As part of the expected changes, OSFI disclosed it would require stress testing to incorporate a 50%, 40% and 30% house price crash for the Greater Vancouver, Greater Toronto and everywhere else, respectively. Most banks and CMHC have been stress testing a 25-30% decline and this letter shows that OSFI is serious about tightening regulations. OSFI will require lenders to hold more capital as a buffer against mortgages in cities that it deems unaffordable (e.g., Toronto, Vancouver, Calgary, etc.). The changes also apply to mortgage insurers and could prompt them to raise premiums when the rules kick in next January.
- On July 27, CMHC said Vancouver is showing "strong" signs of problematic conditions and that they saw evidence of similar problems in Toronto, Calgary, and elsewhere.
- The government's National Housing Strategy, set to be released this Fall, is widely rumored to target foreign investment at the national level, perhaps by beefing up FINTRAC funding/reporting requirements and targeting money-laundering techniques. Other possible/likely changes include further scrutiny of foreign buyers, a crackdown on mortgage fraud, higher down payment requirements, tightening of lending standards, a crackdown on syndicated and/or

private mortgage lending, and the introduction of risk-sharing on CMHC's mortgage insurance.

- The CEO of CMHC on August 16 re-tweeted an article from the Globe and Mail about risk sharing; our take is that there is a high probability that this will be implemented in the near future.

The BC and Vancouver governments in particular are sending the explicit message that they are less welcoming to foreign capital flows. In addition to targeting foreign buyers, the BC government has also warned those who facilitate capital flight via techniques such as "straw buying" and "smurfing" that they will be prosecuted. After a recent series of bombshell investigative reports in mid-September, the Canadian Revenue Agency scrambled to announce that they will be conducting more extensive reviews of BC real estate speculators and that they hired an additional 40 personnel in Vancouver.

It appears that these interventions are taking place even as the market was beginning to slow on its own. Home sales declined nearly 20% year-over-year across the entire

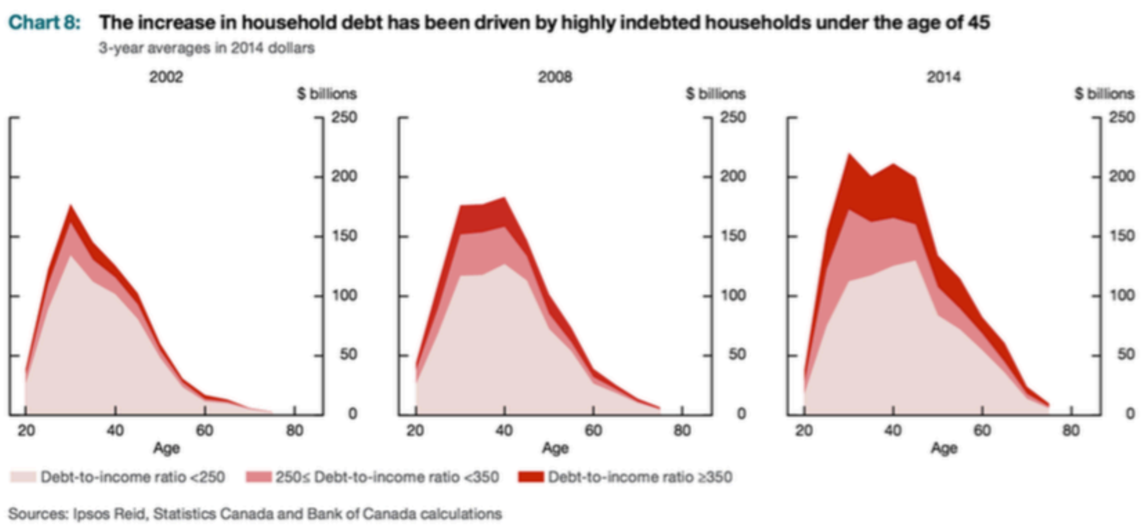
Vancouver metro and were off over 30% in the detached segment. Vancouver West and West Vancouver are likely the best proxies for the Chinese bid in Canadian real estate; detached home sales here fell 55% year-over-year in July after a 33% year-over-year decline in June. Note that the foreign buyer tax was announced on July 25, so the weakness in this segment is not entirely attributable to that announcement. Vancouver home sales have been equally abysmal September-to-date (e.g., detached home sales on pace for 40% drop compared to any other September over past decade), and according to one prominent realtor "the Chinese buyers are just gone". It is too early to know whether this is a blip or a major trend change, but our initial thoughts are that this is a significant change. Appraisers have become more conservative in Vancouver, and lenders/insurers could react by tightening credit availability.

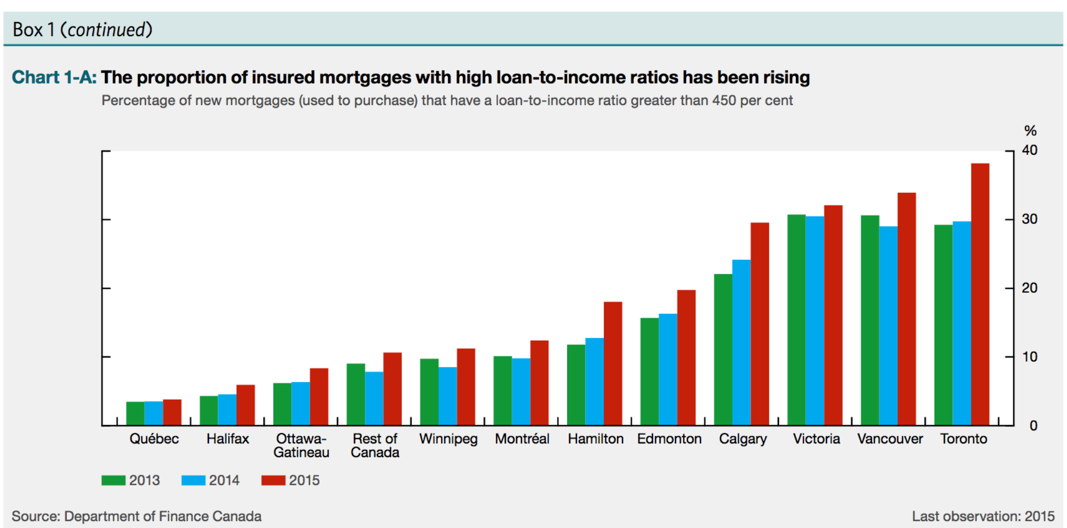
The overarching question now is whether the pipeline of foreign capital flows into Canada will shrink (e.g. because places like California are now relatively more attractive than any city in Canada), or whether a portion of the foreign demand will simply shift eastwards within Canada to less hostile areas such as Toronto. Also unclear is whether the Ontario government will respond with their own tax on foreign capital (we think there is a better than even chance that Ontario follows suit), and whether a deteriorating Vancouver housing market could metastasize to Toronto even without an Ontario tax. It's simply too early to determine, though it's perhaps noteworthy that other Chinese capital havens are seeing slowdowns as well.

Growing Systemic Risks

Canada's economic performance <u>before</u> the down phase of the housing/credit cycle is particularly alarming given the extremely high leverage in the Canadian financial system. Canada's household debt-to-income ratio rose more than any other country beside Greece's from 2007-2014; Canada now has the highest debt to income ratio of any G7 country, exceeding the ratio of the US at its peak in 2006 by a wide margin.

To make matters even worse, household debt is disproportionately concentrated among the riskiest borrowers, as evidenced by a disturbing increase in the percentage of mortgages with loan-to-income ratios above 450% as well as stretched amortization lengths in excess of 25 years:





This increasing proportion of high ratio mortgages renders moot Canada's supposedly stringent recourse laws. For example, the media recently highlighted an artist with $930.5k in debt versus $35k average income. If/when he defaults, what will the lenders do: garnish his wages for 50 years? He will never be able to pay off the debt unless house prices keep rising.

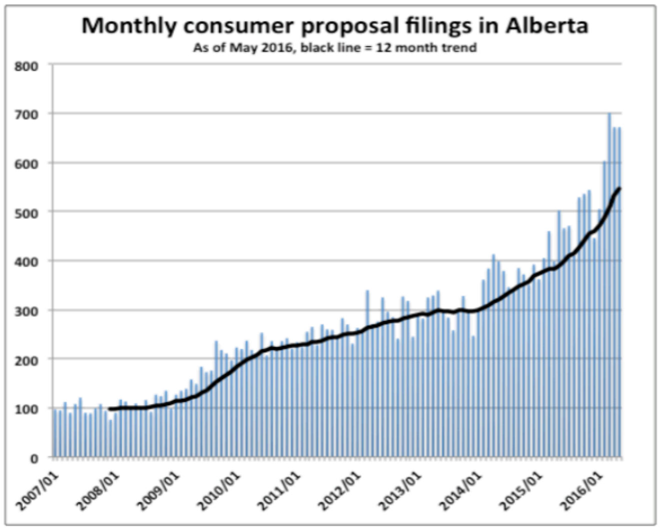
In the US in 2007, mortgage renewal risk was negligible due to the prevalence of 30 year loans. In fact, the US learned this lesson the hard way during the Great Depression:

> *"The 30-year [fixed rate mortgage] was originally designed to avoid the refinancing risk that contributed to the banking crisis during the Great Depression (ironically, mortgages prevalent then were very similar to today's "alternative mortgages," though the maturities typically were shorter)."*
> --Federal Reserve Bank of San Francisco Economic Letter, December 29, 2006 (John Krainer)

In Canada, however, the standard Canadian mortgage term is five years, and many of the more recent vintages of risky mortgages carry 1-2 year terms (i.e. the weighted average term is likely under 4 years now). Canadian mortgages face enormous systemic renewal risk given their short maturities. Standard practice for lenders has been to automatically renew without re-underwriting if a borrower is current. When the cycle turns and psychology switches from greed to fear, however, renewals are likely to tighten, exacerbating the down portion of the credit cycle as homeowners become forced sellers of their houses. Five-year mortgage terms also mean that effectively 100% of mortgages in Canada are adjustable rate mortgages (ARMs) that face interest rate risk if rates were to rise.

Extend & Pretend Partially Masking Credit Deterioration

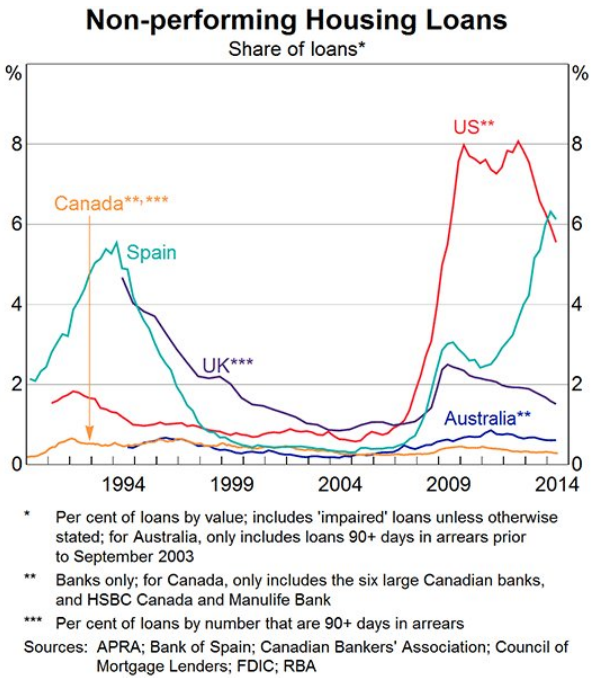
Delinquencies have risen noticeably over the past half year, particularly in Alberta; we expect insolvencies to continue to rise through 2016, particularly consumer insolvencies:



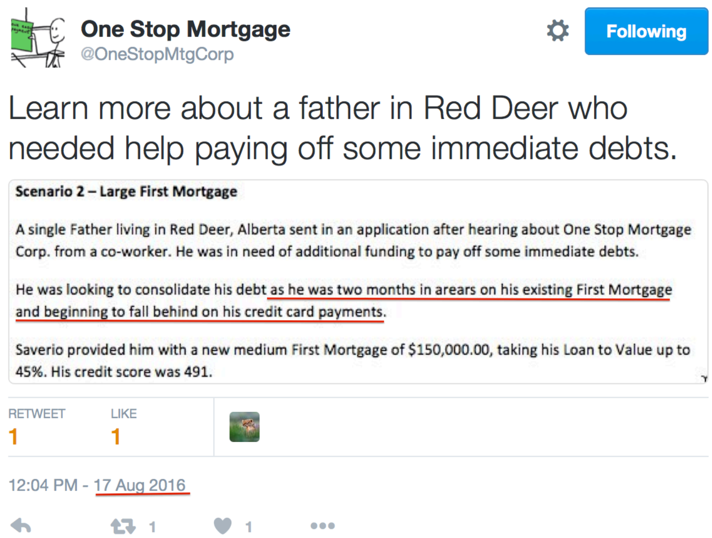
Source: Ben Rabidoux/North Cove Advisors

Delinquencies are also rising amongst Canada's mortgage investment corporations (MICs, one of the major chokepoints of the Canadian credit market); multiple MICs have gated redemptions and/or shuttered.

It's worth noting that non-performing loans generally only rise <u>after</u> housing prices peak and then fall; the US & Spain both showed deceptively low arrears rates during their respective bubbles:



The deteriorating credit trends in Canada are particularly alarming given the widespread use of "extend and pretend" strategies that have maintained the illusion of manageable delinquency rates in the face of mounting financial stress. For the past year we have seen a disturbing proliferation in the use of new subprime debt (e.g., 2nd, 3rd, 4th mortgages from private subprime lenders) to avoid falling into arrears on pre-existing debt.



Other tricks used to keep borrowers out of trouble include selling an existing house to buy a new house (with a lower down payment requirement, extracting equity); refinancings, and loan modification/ "mitigation" of arrears by mortgage insurers and lenders. Loan mitigations are particularly interesting: one of the reasons delinquencies appear puzzlingly low (given the oil shock) is that Canadian lenders and insurers let borrowers skip payments (tacking the difference on to the outstanding balance), extending the length of the amortization period to make monthly payments more affordable, etc. For example, watch this video of **Genworth Canada's Homeowner Assistance Program.**

What follows is an excerpt from a recent company filing highlighting the use of "credit management strategies"; the company took what has to be a world-record setting **0.00%** (yes-you read that correctly. **0.00%**! In our 16+ years in the business we have never seen anything like that) provision for credit losses in the recent quarter:

The Company's active management of credit risk and our workout efforts continue to yield positive results. The success of our credit management strategies is highlighted in the metrics in Table 11 below. We believe that these measures reflect the health of the Company's mortgage portfolio and indicate that our allowances adequately provide for the risk of loss.

Table 11: Mortgage credit metrics

($ THOUSANDS)	Jun 30, 2016	Mar 31, 2016	Jun 30, 2015
Provision for credit losses	$ 105	$ 227	$ 830
Provision for credit losses – rate[1]	0.00%	0.01%	0.03%
Gross impaired mortgage assets[2]	33,531	36,048	27,566
Net impaired mortgage assets[2][3]	32,181	34,783	24,382
Net impaired mortgage assets as a % of total mortgage assets[2][3]	0.20%	0.22%	0.18%
Allowance for credit losses	33,240	33,155	34,007
Allowance for credit losses as a % of total mortgage assets	0.20%	0.21%	0.26%
Allowances for credit losses as a % of gross impaired mortgage assets	99%	92%	123%

(1) *See Non-Generally Accepted Accounting Principles Financial Measures section of this MD&A.*
(2) *Uninsured mortgages are deemed to be impaired at the earlier of the date they have been individually provided for or when they have been in arrears for 90 days. Mortgages guaranteed by the Government of Canada are deemed to be impaired when payment is contractually past due 365 days.*
(3) *Net impaired mortgage assets reflect gross impaired mortgages less individual allowances.*

Canadian financials have arguably the lowest provision for bad debt among financial institutions of any country in the world. This accounting trick has artificially inflated bank earnings for years and magnifies the risks to the banks when the credit cycle turns. Canadian banks also have one of the lowest capital adequacy ratios (CET1) in the world (ranking 34th out of 35 major countries), increasing regulatory risks for the Canadian banking system.

Alberta

Alberta's monthly unemployment rate climbed to 8.6% in July, its highest level in nearly 22 years, and stands at 8.4% in August; we expect unemployment to deteriorate further in the coming year. On a year-over-year basis, the overall number of employment insurance beneficiaries in Alberta has increased by 59% to record levels as consumer insolvencies continued to surge and wages declined. Calgary year-to-date home sales plumbed 20 year lows. The situation will likely worsen now that employment insurance and severance packages are running out. Meanwhile, the sharp slowdown in housing starts (-41% YTD) and dwellings under construction in the province (-22% y/y, at 5-year lows) point to major impending layoffs in this sector—one of the most important employers in the province. The 2016 year-to-date provincial revenue from oil and natural gas rights sales hit its lowest level since 1992, straining governmental coffers.

Calgary's office vacancy rate hit a 30-year high (22% vacancy rate). CAPREIT "strategically reduced" rental rates by 15%-17% in Alberta in 2Q and offered first month free rent. Dream Office REIT took a 42% reduction in fair market value of their Alberta office properties.

China

Virtually all of the difficulties facing the Chinese economy that we raised in our January 2015 letter have persisted and/or have intensified; China now faces a host of additional problems as its bubble economy teeters on the edge, non-performing loans strain its $30 trillion banking system (bad loans hit an 11-year high in June), and the government wages an untenable war against both credit deflation and the FX markets.

Reversing two major trends that have provided a tailwind to the global economy for decades, unit labor costs in China are becoming uncompetitive and the urbanization of China (villagers moving into the cities) appears to have peaked. We are now witnessing a noticeable slowdown in population flows into first-tier cities from 2010-2015 versus 2000-2010, and possibly even a trend towards de-urbanization. Demographically, China's labor pool has passed its peak working age, implying that productive economic activities may not recover for at least a generation. Structurally, China is moving toward greater governmental control over the economy rather than less, meaning that its productivity will likely deteriorate further, which in turn implies that the savings pool available to the world will disappear. If this is in fact occurring, it will have important ramifications not only for Canada but for the world.

Beijing responded to an economic slowdown earlier in the year by ramping up government spending, cutting interest rates and opening the credit/monetary spigots. China's M1 Money supply has risen at the fastest pace since China's 2009-2010 infamous stimulus after the 2008 Crisis. Despite these measures, manufacturing and the productive sectors of the Chinese economy continue to exhibit weakness, and trade remains anemic (exports are off 4.4% and imports down 7.4% year-over-year in the past quarter, leaving the total at 5-year lows). China risks worsening its problems, as the bulk of the lending has flowed to inefficient and bloated state owned companies and speculative activities (including housing, which has attracted official disapproval). Long-term loans to households are up nearly 30% y-o-y and account for more than half of the new money supply; banks bought bonds worth 150% of new issuance and stocks worth 35% of the market cap of the Shanghai index.

Schizophrenic policy responses have included a Chinese regulator suggesting that banks should not foreclose on too many failing companies (perhaps Canada is taking lessons from the Chinese government?) and a suggestion that banks swap debt for equity with their more important creditors. At the same time, China is attempting to rein in the rising risks in the country's huge "shadow banking" sector by tightening the rules on the amount of "wealth management products" that banks can issue as well as on its loosely-regulated private funds management industry, revoking the licenses of over ten thousand firms. The risk here is that any crackdown on credit could choke off funding for Chinese companies and trigger a fresh round of problems in the Chinese property and stock markets, which would have negative consequences for Canada.

China is resolutely attempting to halt capital flight by applying pressure both at home and abroad. This past week, Ottawa announced that it is negotiating an extradition treaty with China: if implemented this would be another nail in the coffin for the Chinese housing bid in Canada. Two more of China's former top commanders were taken away for corruption investigations in recent weeks, likely due to a renewed crackdown on "corruption", and there have been another recent series of "suicides" amongst senior officials. China's new bank regulation requires banks to confirm that foreign wires of $50k were legitimately earned and that taxes were paid; while there are still workarounds to launder money, the government is clearly tightening the screws.

Late in June, CITIC (a large bank owned by the Chinese government) launched a lawsuit against a Chinese fugitive and current resident of B.C., alleging that he defrauded the bank in China and used the fraudulently conveyed proceeds to purchase three homes worth $7.3mil in Vancouver. This represents the first Chinese asset recovery case according to the Vancouver lawyer who represents CITIC: "Yes Vancouver, China is coming after proceeds of corruption and proceeds of crime stolen from them and parked in Vancouver!". Since then, lawyers in Vancouver have seen a notable increase in the number of B.C. court cases filed by Chinese corporations looking to seize real estate assets from Chinese immigrants in B.C; similar cases are being filed in Toronto, as well. At the very least, the publicity should produce a sentinel effect for Chinese speculators, which may further hinder money laundering into Vancouver. Interestingly, the CITIC fugitive had set up shell companies and obtained several 100% (!!!) LTV mortgages from banks in Canada. As we have long maintained, what <u>appears</u> to be a Chinese "cash buyer" in Canada is frequently simply someone who levered up back in China and/or from Canadian financial institutions.

A barrage of stories in the mainland Chinese media warning that the risks in the Canadian housing market are worse than they were in the US in 2006 may also be souring Chinese speculators on the Canadian housing market. A combination of a Chinese crackdown on money laundering, an increasingly hostile tax regime for foreigners in Canada, and a break in Chinese speculative psychology as a result of negative media stories could cause serious damage to the Vancouver bubble.

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