Mackenzie Bluewater Team | January 2018

Canada's 'Wall of Worry'

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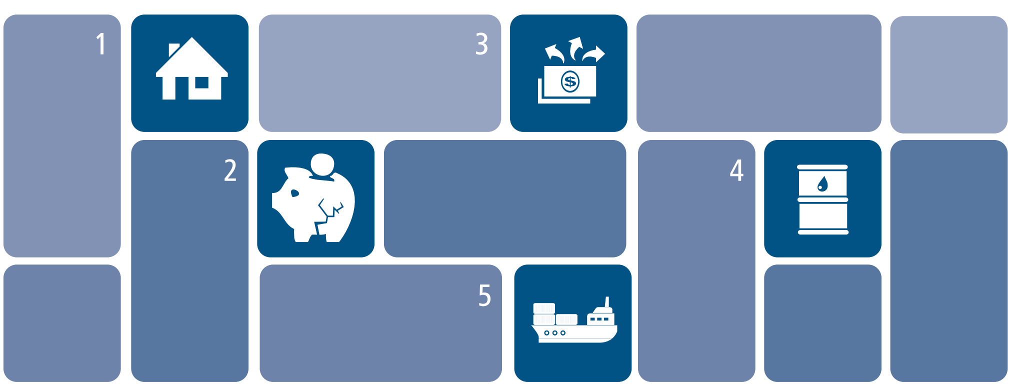
While Canada is expected to be the second-fastest growing G8 nation in 2018, the economy is faced with many headwinds that we expect will slow future growth. Domestic GDP growth has been driven more by a strong housing cycle, impacting residential construction and durable goods, and less by sustainable components including investments and exports.

Key Takeaways

- Our team has identified key issues facing the Canadian economy, including the excessive dependence on growth from the housing market, record levels of consumer indebtedness and rapidly rising minimum wages in Ontario and Alberta. Moreover, technological and policy changes in the energy sector and uncertainty around NAFTA renegotiations add to our concerns.
- Given these issues, the Mackenzie Canadian Growth Fund maintains a low exposure to domestically-oriented Canadian businesses and is focused on Canadian companies with geographically diversified revenues. Our purely domestic businesses are in resilient industries that we feel will not be seriously impacted if an economic slowdown in Canada does occur.

The 'Wall of Worry' Facing Canada's Economy



1. Housing Prices Driving Economic Growth
2. Record Consumer Indebtedness
3. Rising Minimum Wages in Ontario and Alberta
4. Structural Change in the Energy Sector
5. Significant Dependence on US Trade and NAFTA Uncertainty

1. Housing Prices Driving Economic Growth

In Canada, much of the recent growth in the economy has been driven by the housing cycle. There has been a substantial run-up in house prices, mainly in the Toronto and Vancouver areas. Several rounds of mortgage tightening rules, combined with higher interest rates, appear to be having a dampening effect on the housing market. However, there is still uncertainty as to whether prices will continue to trend upwards, stabilize or decline.

While low inflation should lead to an upward re-pricing of assets (including housing), we find it impossible to determine how large or sustainable the adjustment will be. Nonetheless, annual house price increases of 15-20% when incomes are rising at 2-3% inevitably leads to a widening affordability gap. Continued appreciation at that rate could eventually result in median new home buyers spending their entire after-tax income on mortgage payments, with no room in their budgets for essentials like food, gas and clothing. In light of this, we are watching the recent slump in the Toronto housing market to see if it marks a top in the cycle, or just a pause. With 7%* of Canadian employment tied directly to residential construction, more than double the current US level, a stall in residential construction may have material implications for economic growth.

2. Record Consumer Indebtedness

In September 2017, Statistics Canada reported that consumer debt-to-income levels reached a record high of 168% and the OECD recently suggested that Canadian household credit levels are among the highest in the world. High consumer indebtedness, much of which is linked to real estate, may pose significant risks to the domestic economy if house prices begin to decline or interest rates keep rising.

3. Rising Minimum Wages in Ontario and Alberta

Ontario and Alberta have planned minimum wage increases totaling more than 30% over an 18-month period. A recent study from the University of Washington found that while small increases to the minimum wage had a negligible impact on employment levels, subsequent larger increases resulted in disemployment to more than offset any gains from wage increases. Given the magnitude and pace of Ontario's minimum wage increases, the Keep Ontario Working Coalition suggested 185,000 jobs in the province are at risk following the implementation of the minimum wage bill. Canadian retailer commentaries around increased automation and optimization of part-time and full-time workers suggest this is not an inconceivable outcome. Loblaws has recently announced layoffs of 500 workers, Empire laid off 800 workers and Metro eliminated approximately 280 jobs.

4. Structural Change in the Energy Sector

The energy sector comprises nearly 10% of Canada's economy and approximately 20% of the S&P/TSX Composite Index. We have written extensively on electric vehicles and their likely impact on the energy sector. This technological disruption is the confluence of two factors: consistently improving technology and government policies aimed at moving away from fossil fuel consumption. As electric vehicles become more cost-competitive and government policies incentivize consumption away from fossil fuels, we are concerned about the medium to long-term impact on oil demand. A slower growth rate of oil consumption and eventual decline should put pressure on prices in the early part of the next decade.

*Source: Deutsche Bank

5. Significant Dependence on US Trade and NAFTA Uncertainty

Uncertainty surrounding the NAFTA renegotiation process has added to our concern about the issues facing the domestic economy. NAFTA has benefitted both Canada and the United States, with total trade well balanced between the two countries. However, on a relative basis, trade with the United States accounts for just under 20% of Canadian GDP, while trade with Canada accounts for less than 2% of US GDP. It appears to us that Canada is at a large negotiating disadvantage and we expect that any adverse outcome will have negative consequences for companies that have an exposure to trade with the US, and for the Canadian dollar. From an investment standpoint, we are avoiding companies that are highly reliant on trading with the US and shipping goods across the border.

Positioning Against the 'Wall of Worry'

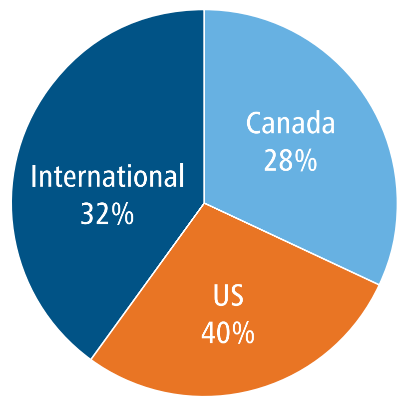
We are focused on those Canadian companies that have meaningful international exposure, that are less constrained by the domestic economy and are able to capitalize on growth opportunities elsewhere. Greater geographical diversification in their business mix lowers reliance on any one particular region, which ultimately translates to lower risk. This includes companies like CCL Industries, Spinmaster and CAE.

Our pure domestic exposure remains limited and defensive in nature including best-in-class dollar stores and telecom providers including Dollarama and Telus.

The Mackenzie Canadian Growth Fund has approximately 50% exposure to Canadian equities but less than 30% of portfolio revenues are derived from Canada.

We have reallocated capital from sectors that are overrepresented in Canada to buy high quality, superior growth companies that are extremely stable and that just don't exist in Canada. We have a substantial underweighting to the Financials and Energy sectors, which dominate the S&P/TSX Composite Index, together comprising approximately 55% of the index, and we are overweight Healthcare and IT, which are all US and global-centric companies.

Portfolio Revenue by Geography



Source: Company filings, calculations by Mackenzie Investments.

Summary

In this environment, the Mackenzie Canadian Growth Fund holds Canadian companies with revenues that are geographically diversified and purely domestic businesses that are in resilient industries. The flexibility to invest up to 50% of the portfolio in foreign equities contributes to portfolio stability, diversification, and slightly higher growth rates relative to Canadian equities.

Talk to your financial advisor to learn more about the Mackenzie Canadian Growth Fund.

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