

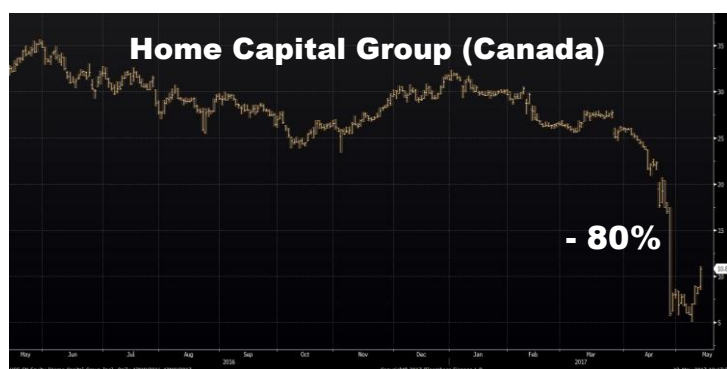
When Something Is Wrong With My Baby

As discussed earlier in the daily Morning Update, the Moody's announcement to downgrade the credit ratings for Canada's six largest banks is a flashing light for the financial markets.

Toronto-Dominion Bank, Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada and Royal Bank of Canada each received a one notch downgrade, and all six banks remain on negative outlook.

Moody's cited, "expanding levels of private sector debt could weaken asset quality in the future" and "continued growth in Canadian consumer debt and elevated housing prices leaves consumers, and Canadian banks, more vulnerable to downside risks facing the Canadian economy than in the past".

The catalyst for this proactive move by Moody's, stems from the woes playing out in Canada's largest non-bank lender, Home Capital Group. Home Capital's share price is down up to 80% since experiencing a run on deposits. In lieu of this drain on the balance sheet, Home Capital arranged an emergency \$2 billion credit line with an interest rate of 10%, and a \$100 million fee (according to Canada's Globe and Mail newspaper). The share price has clawed back some losses on speculation the group will sell-off assets.



Home Capital shares plunge (Bloomberg)

Moody's played down the risks by suggesting, "we do note that the Canadian banks maintain strong buffers in terms of capital and liquidity". However, they also added Canada's banks simply have not been "tested" at the current levels of indebtedness.

If these sentiments sound strikingly familiar, they should, because commodity rich nations including Canada, New Zealand and Australia have observed sharp appreciations in house prices and accompanying household debts.

Financial regulators in each of these three countries have tightened up on lending in the name of financial stability. The salient risk being, the housing sector represents a much greater proportion of GDP growth. Hence, a slowing in housing threatens a slowing in broader economic activity.

Commodities are an important source of income for each of these economies. That is, the capacity to repay higher levels of household and public debts. The good news is commodity prices are broadly higher since the lows of early 2016. The bad news is the prices for oil, dairy and bulk commodities are falling again and are lower this calendar year.

The Reserve Bank of New Zealand's, Graeme Wheeler, struck a cautious tone this week when he talked down any chance of a rate hike and talked up all manner of risks. Monetary policy is to remain accommodative for a considerable time due to numerous uncertainties.

Here in Australia, the federal government expect wages growth to return to 3% by 2018/19, and even higher thereafter. Whilst these are achievable they are ambitious given the more recent declines in commodity prices.

Housing markets, including residential construction, have been powerful drivers of economic activity in Canada, New Zealand and Australia for some years now. However, there are signs that this sector is slowing, and we can expect bigger economic impacts this time around. For instance, the value of housing stock is 3.8 times the value of GDP (as at December 2016), with much housing supply still to come to market this year.

"The strength of a nation derives from the integrity of the home." ~ Confucius