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5 *Facts* You Should Know

929,000

Canadians applied for EI in the week ending March 21st.

-24%

TD Bank's forecast of annualized rate of economic contraction in 2nd quarter - (CIBC -18.7%, Scotia Bank -10.7%, BMO -10%).

"Unlimited"

The amount of money the Federal Reserve has committed to keeping the credit markets functioning. They spent $587 billion from March 19 to March 25.

500,000

The number of mortgage deferral requests in the last two weeks, which if granted work out to $663 million/mo. in payments.

$4

The price per barrel of Western Canadian Select crude this week.

Quote of the Month

“There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of voluntary abandonment of further credit expansion, or later catastrophe of the currency system involved.”

Ludwig Von Mises
economist, philosopher

Bonus Quarantine Quote

“After years of wanting to thoroughly clean my house but lacking the time, this week I discovered that wasn't the reason.”

Your Name Here

What's Going On?

- Don't Say We Weren't Warned
- COVID19 The Tipping Point
- The Big Question
- The Next Surprise

So What's Going On?

In the wee hours of September 16, 2019 a number of financial institutions and other big corporations were looking to borrow money for between one and 14 days. Nothing unusual about it. It's the overnight lending market called the repurchase or "repo" market". Companies would hand over security - get the money from the lending financial institution and promise to buy back the security at a slightly higher price the next day. The slightly higher price represents the interest.

It's straightforward and a prominent part of the financial system. Except on September 16th virtually no one wanted to lend the money because they were unsure the borrower would pay it back by buying back the security the next day.

A similar crisis had taken place during the subprime credit debacle in 2008. Major companies like AIG, Washington Mutual, Lehman Brothers were awash with non performing loans and securities - so nobody wanted to lend to them.

Last September the big concern was Germany largest bank, Deutsche Bank because it has a massive derivative and futures market problem - in the neighbourhood of $45 billion dollars in potential liabilities. Lenders were worried that the borrowing company may have exposure to Deutsche Bank's problems, which could blow up any minute.

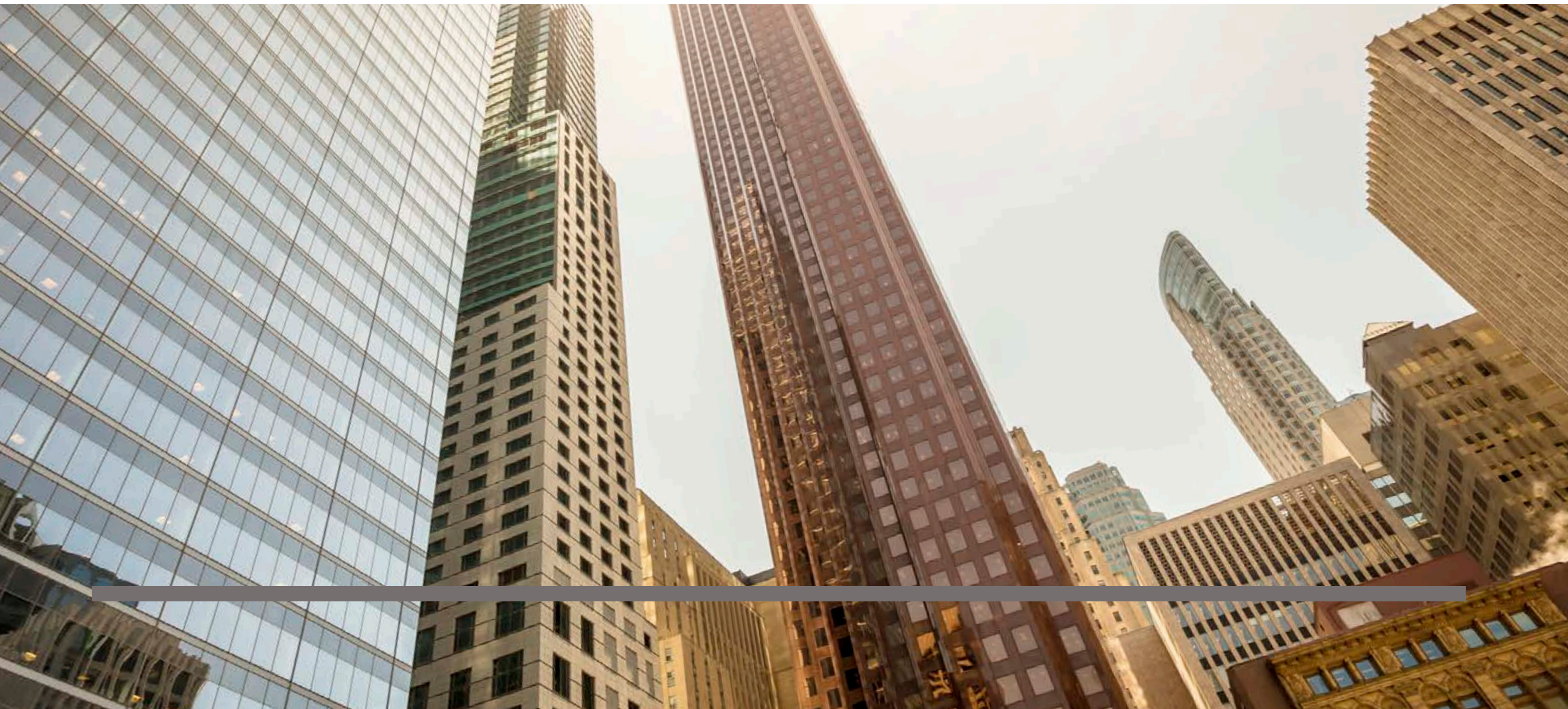
Compounding the liquidity problem was Europe's $12 trillion in negative yield bonds. No one wanted to buy them and be guaranteed less money when they matured, so instead they put the money in safety deposit boxes or sent it out of the country. In other words, the system was short of cash and confidence.

At the risk of oversimplifying, on the night of September 16th, the annualized rate for borrowing was 2% but suddenly there were no lenders. So the rate went up to 4% then 5% - still no institution was willing to lend even at those rates. Ultimately, the rate went all the way to 10%.

Think about that. The borrowing rate went up 500% in a matter of hours. The Federal Reserve was forced to step in to provide the funds to borrow in order to bring borrowing rates back down and prevent a major credit crisis. And they have literally put in billions every day since.

> **"In other words, the system was short of cash and confidence."**

This is the essence of liquidity crisis that continues to this day.



COVID19

While the problems in the credit market were obvious for months, the COVID19 crisis further exposed the significant problems in the system. Stocks always fall because there are more sellers than buyers but the lack of credit and cash in the system exacerbated the problem, which caused the massive downside moves.

Shocking Stat

On March 30, 2019 - 2.4 million people flew in the US. Same date this year - 150,000 travellers - a 93% decline.

In short, we've witnessed the unravelling of the credit bubble that pushed prices to record highs in the stock market.

The lack of liquidity forced both the New York and Toronto Stock Exchanges to shut down several times in the last five weeks because even big name stocks went "no bid." So they closed the exchanges for 15 minutes to make time for buyers to come to the table in order to produce an orderly decline.

The same thing happened in the fixed income market. There were far more sellers than buyers of corporate bonds and quality preferred shares. In many instances there were no buyers.

It's not difficult to understand why with a question. Would you like to lend money to Air Canada, Carnival Cruise Lines, a restaurant chain, a retail outlet whose now been forced to close their doors, (which is what you're doing when you buy a bond.) I doubt it but how about lending the government of Canada money for five years and receive ¾% annually. Probably not.

Without lenders willing to buy bonds or other credit instruments things grind to a halt and that's the biggest fear of central banks. Can you imagine what would happen to the real estate market if no institution was interested in approving mortgages? Sales would stop and that's what the central banks are trying to avoid.

That's why the Bank of Canada has pledged to spend $5 billion minimum every week to buy bonds or asset backed securities from financial institutions. That way the financial institution gets money with which to lend with. When you hear the term Quantitative Easing that's what they're talking about.

Short term lending of between one and 90 days has also come to a halt because lenders don't want to take the risk given all the uncertainty so now central banks are providing the money for the system to continue to operate.

In the US the Federal Reserve has promised unlimited amounts of money in order to keep both short and long term markets functioning.

The Biggest Question of The Decade

How long can the central banks keep interest rates down because without their intervention interest rates would have gone up as the perceived risk from the economic disruption caused by COVID19 increased.

As the COVID19 scare took hold money left other parts of the world and went primarily into US stock and bond markets and to a lessor extent Canada. There were record highs in US stocks and the US dollar while government treasury bonds rose and rates dropped. But then worries over the impact on business and the economy took centre stage. Travel bans took effect, tourism was dealt a body blow, Chinese demand for natural resources dropped dramatically and the impact on various companies and the overall economy started to be understood. Manufacturing supply chains were interrupted. Major companies like Apple announced manufacturing delays and store closures, which precipitated far more aggressive selling in the stock market.

Worries that cash flow problems for business would lead to defaults on existing credit. The market decline triggered billions in mutual and hedge fund redemptions, which fueled more selling. People and funds who borrowed money to buy stocks were forced to sell and all the while, the relentless stream of bad news continued fueling even more selling.

In the process money continues to flow into the safety of US and Canadian government bonds. The rate on the 10 year government of Canada bond dropped to a low of .47%. from 1.5% four weeks earlier. At the same time the 5 year government of Canada bond dropped to .53% from 1.15%.

The key point to understand is that when it comes to global capital, the US is seen as the safe haven. When the COVID19 panic hit Europe and emerging markets, money didn't flow into their own bond market - it went to the US, which fueled the rise in the US dollar.

The big question is - when will confidence leave the US bond market? Will the catalyst be the growing pension problems at the state and municipal level? Will it be problems in the Social Security system? Will it be triggered by the exposure of US banks to international problems or a severe domestic slowdown force defaults? What about exposure to the US oil patch that is suffering because of the Saudi/Russia price war?

The point is that just like in all other parts of the world, credit risks are rising which puts upward pressure on interest rates.

The toilet paper trade - US imports $309,520,502 worth of toilet paper. It exports $177,178,117. American has $132,342,465 in toilet paper left over.

The Most Asked Question

Hundreds of thousands of Canadians are asking the banks for a deferral on mortgage payments while others are looking to take advantage of the Bank Of Canada's three half point emergency rate cuts since March 4th and are asking about extending their existing mortgage or getting a new one.

The big question is whether it's better to take a variable rate or fixed term.

Before answering consider that all the pressure on mortgage rates is up. That's why despite the fall in bond market yields, the 5 year fixed term is up. And despite the three half point emergency rate cuts and the accompanying drop in prime rate - new variable rate borrowers haven't had the full advantage because the formula for establishing the rate has changed with the elimination of the "prime minus" provisions.

At the same time, the 5 year fixed mortgage rates haven't reflected the full drop in the 5 year bond yields. In fact, recently 5 year fixed rates have been drifting upwards while the bond yields dropped.

It's a reminder that the Bank of Canada can lower the bank rate and the yields of 5 year and 10 year bonds can fall but that doesn't guarantee the mortgage rates will fall accordingly.

One of the big misconceptions is that banks and other lenders have to pass along the drop in the Bank of Canada's benchmark rate. They don't. The government cannot force anyone to lend. So even if the benchmark rate falls another ¼ or ½% it's no guarantee that the mortgage rates will drop too.

I suspect that banks and other major lending institutions are worried that rates are going to rise, which is why they are reluctant to lower their rates further with the risk increasing.

The Big Surprise

Central banks don't control interest rates - lenders do. The key to understand is that when interest rates rise, it won't be because central banks start raising the bank rate. It will be because confidence in the system and government starts to erode.

As the lenders' confidence erodes the ability of central banks to keep rates down will diminish. It's not difficult to understand. It's happening right now in Europe and emerging markets. In the US, the Federal Reserve is committing trillions of dollars to the credit market in an effort to maintain confidence because they know if confidence starts to diminish, the upward pressure on rates will explode as investor demand a higher risk premium.

This is the financial tug of war in our lifetimes. Can the central banks maintain confidence in the credit markets or will sovereign debt and unfunded pensions liabilities exacerbated by the economic decline caused by efforts to contain COVID19 dominate?

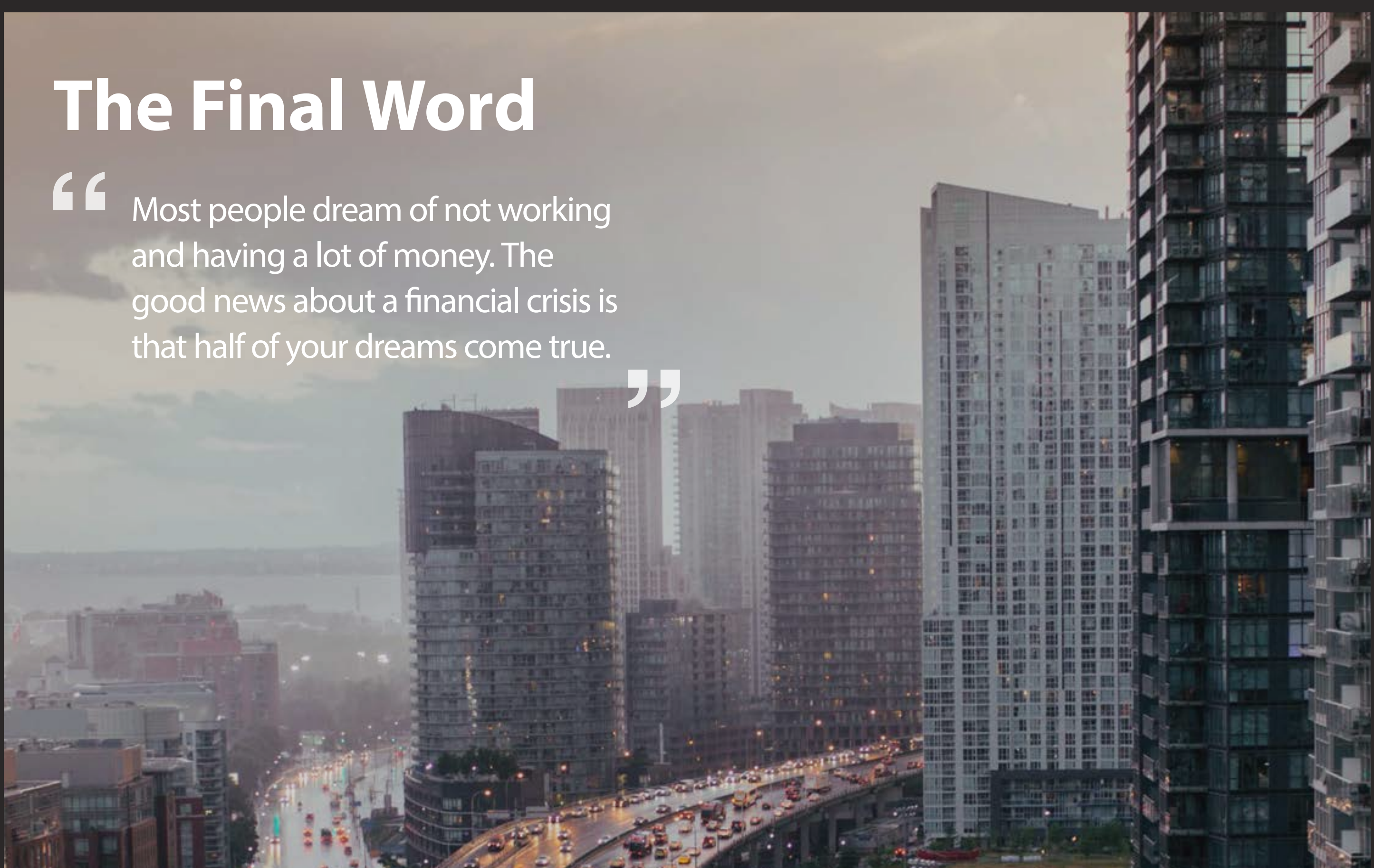
So back to the question - should someone take out a variable rate or lock in for 5 years - there are a great many individual factors that influence the decision but borrowers should know that all the risks point to higher rates. The bank rate is at .25% - how much lower can it go? To zero? Negative? My point is that the risk on the upside is much higher. Just like bond rates went down so dramatically in the last 6 weeks - they can go up just as fast if confidence in government erodes.

My approach is that people should know the risk they're taking before they decide. And if they're comfortable forecasting interest rates there are many other ways to play it besides with their home.

Final Note

On the positive side it's a great time to be a borrower with a locked in rate. As for stocks? The probabilities are rising that there is another significant leg down in the short term but as confidence leaves government, investors will leave the bond market, prices will fall, rates will rise just as they are right now in Europe and other parts of the world and ultimately the money will flow into quality stocks pushing the US indexes to new record.

The time frame for all of this - no longer than 2 years but maybe it starts as early as after the 2nd quarter.



About
Michael Campbell

One of Canada`s most respected business analyst, Michael is best known as the host of Canada's top rated syndicated business radio show MoneyTalks, and Senior Business Analyst for BCTV News on Global.

Mr. Campbell is the Economist for VERICO, Canada's most respected network of independent mortgage brokers.

About
VERICO Canada

VERICO was founded in 2005 with a single idea: to unite top mortgage originators in Canada and create additional opportunities for this group of highly driven professionals. Together, we knew we could make a mark on the Canadian mortgage industry.

In 2010, we reached $10 billion in collective loan volume, a number that rivaled the mortgage business of the big 5 banks in Canada.

Operating at the highest degree of professionalism, excellence and ethical standards, we originate over $15 billion by helping 45,000+ families annually with their mortgage needs.

VERICO was named Best Broker Network of the Year in 2009, 2013, 2014 and 2016.

MORTGAGE AWARDS OF EXCELLENCE 2019 WINNER NATIONAL NETWORK OF THE YEAR

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