the daily dirtnap

30JAN18 | dillian@dailydirtnap.com | 843 448 6141 | VOL 10 NO 20

TON OF BRICKS

Facebook is good for something. Someone posted a video the other day of some guy turning on GnR and dancing on his kitchen table to "Welcome To The Jungle," then taking a giant digger on the floor, landing like a ton of bricks, shaking the entire room. I must have watched it about 30 times, I was crying, I was laughing so hard. One of the rare occasions that FB made me laugh. Well done.

For years I said that there would be no soft landing in Canada, but a casual observer might look at Canada and say they are having a...soft landing. Prices are off a bit, especially in Toronto, but have not crashed.

That doesn't tell the whole story, because the level of debt in Canada is insane, and everyone is rolling around with about $70K in home equity lines of credit that people are just making the interest payments on. It's a grave situation. Meanwhile, the Bank of Canada has hiked rates three times, and debt service costs keep going higher. Higher interest rates are turning out to be the vise that is cranking down on Canada's skull.

I think Canada's housing bubble is a bit different that the U.S. housing bubble, which should be obvious, but isn't. The U.S. was a bit more of an asset bubble—high home prices—which was solved by supply. They've been adding supply in Canada, too, but demographics remain strong. In Canada, it's more of a debt issue, so you have to ask yourself—what is going to get people to suddenly default on this mountain of debt. The answer to that is: a recession, but then we are back at the hen/egg problem. You won't get a housing bear market unless there is a recession, but you can't get a recession without a housing bear market.

One thing we've also learned in the last year is that if you're waiting on a recession, you're not just waiting on a recession in Canada, you're waiting on a global recession, and we know how useless it is to get short something and wait for a recession.

So why short Canada at all? Why not just by S&P puts?

Because the downturn in Canada will be much more severe, is why. With equity moves plus FX, you could see the TSX down 75%. We're talking about potentially one of the biggest debt implosions in the history of finance. This was the thesis all along, but in 2013 you could look at this and say that Canada, idiosyncratically speaking, could go kablooey on its own. That is no longer the case, which diminishes the attractiveness of the trade. But it's still going to be massive.

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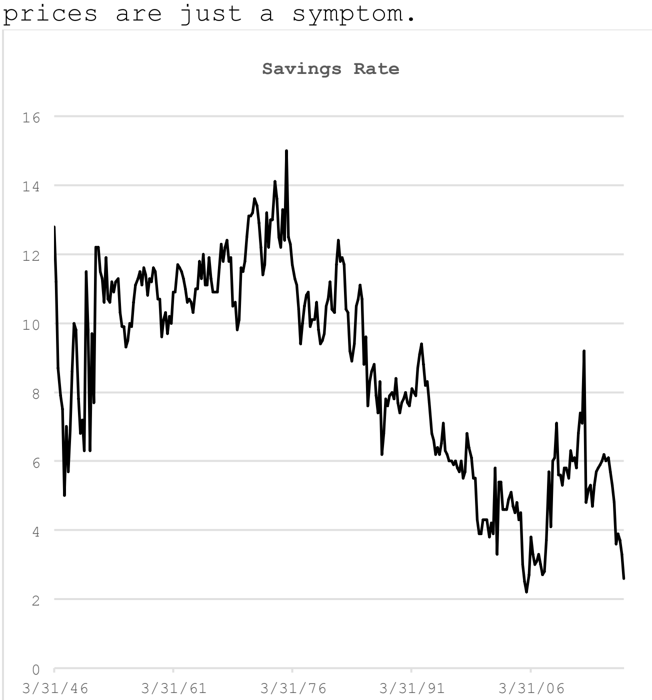
In short, I spend less time thinking about high housing prices and more time thinking about debt. It's hard to imagine, because we in the U.S. have deleveraged so much. We don't save much anymore, but we never re-leveraged, outside of a few student loans. All the releveraging has been in corporates. So it might be hard to remember just how in debt the American household was in 2006. Remember the negative amortization mortgages? Remember ditech.com? Remember the dancing alien in a bikini banner ads? Banks were throwing money at you, whether you needed it or not, and whether you could qualify for it or not. Same in Canada. The high house prices are just a symptom.

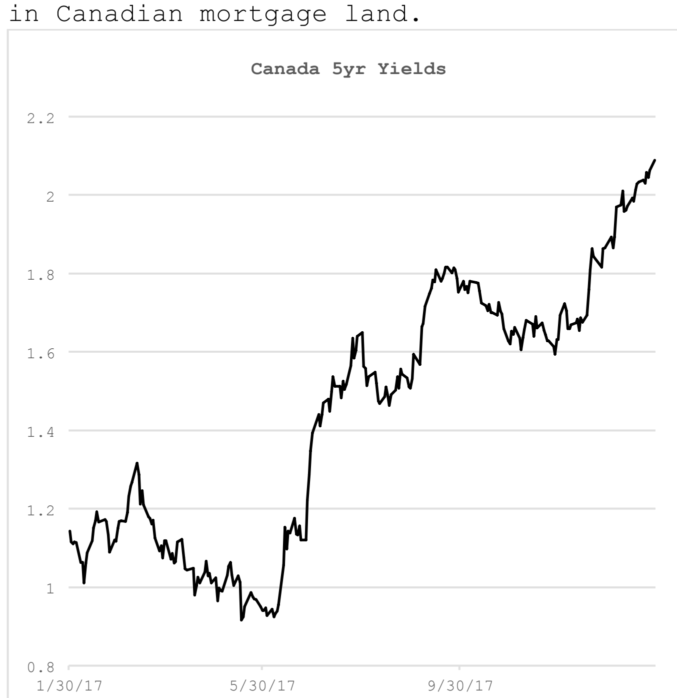


Source: Bloomberg

By the way, have you seen the savings rate lately? Back to the all-time lows. Do you see where the highs were? In the bear market of 1974.

Poloz has got people in Canada all fired up about more rate hikes, but honestly, I think he is done for the time being, partially because of the debt, and partially because of NAFTA. I hate to be unkind, but Poloz is the ultimate path of least embarrassment central banker. He hiked rates because it would have been embarrassing to leave them alone with GDP printing 4%. He'll hold steady because it would be embarrassing to, well, actually cause a recession. If GDP keeps printing 4%, he might hike again, but probably not.

Mr. Market is doing lots of tightening in Canadian mortgage land.



Source: Bloomberg

Meanwhile the yield curve has been flattening relentlessly in Canada, like it has here, except for the last month or so, where people have gotten a bit excited about growth, and Poloz has hit the brakes.

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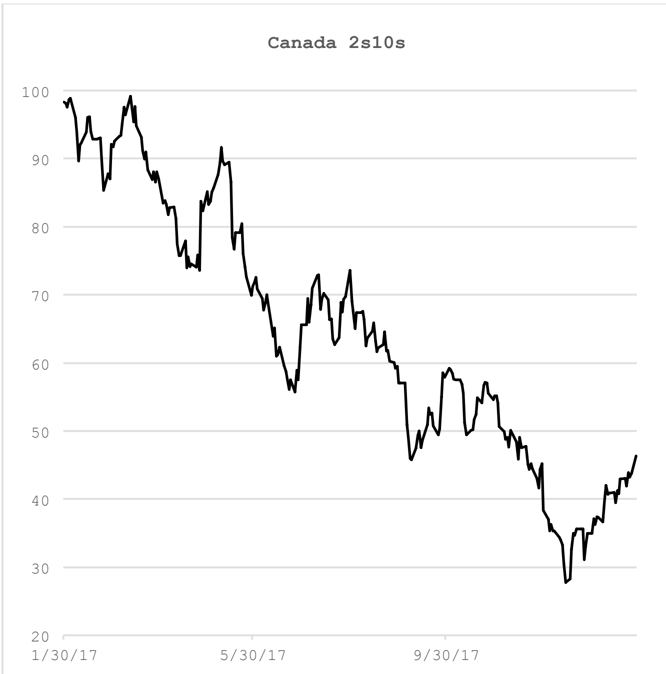
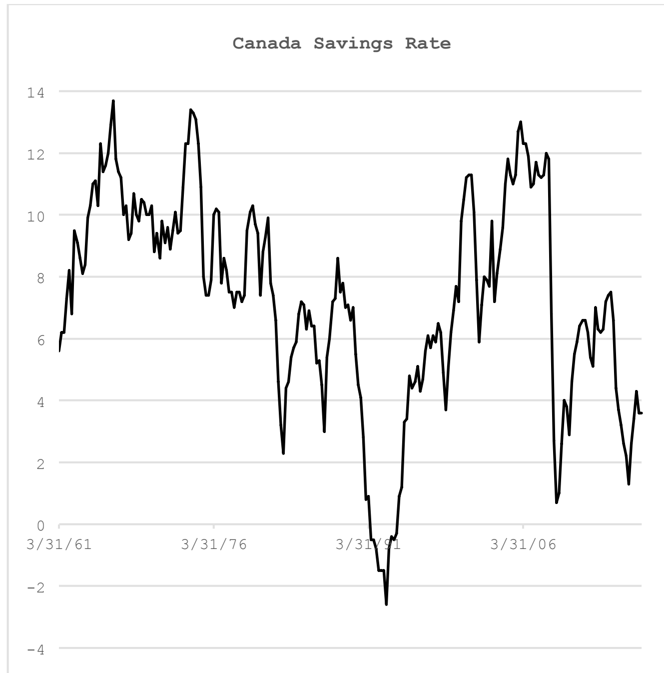


Source: Bloomberg

2s10s got below 30 in Canada, which would have set off some alarm bells if it happened here.

Oil is a non-factor here because the basis between Western Canadian and WTI has pushed out over 30, and there is no way that the poor Albertans are going to get a pipeline built as long as Trudeau is in charge. The politics of that are pretty interesting—the environmentalists are basically keeping Alberta in a state of semi-recession, and a lot of the money that pays for that activism comes from the U.S. The whole thing stinks.

I'm going to paraphrase my friend Harley Bassman here, and say that inverted yield curves do not cause recessions; inverted yield curves are usually found loitering near the scene of the crime. So are low savings rates. Since we have a little more space, I found a chart of the Canadian savings rate, which is also loitering near the scene of the crime. It got lower during the *last* housing bubble.



Source: Bloomberg

This has been a tuffy. I thought I was going to have a heart attack last summer. Seriously. That took about two years off my life. Canada wants CAD weaker; they will probably get CAD weaker. Not sure if you have been paying attention, but CIBC has been doubling and tripling down on residential real estate while the other banks have pulled back. People in Toronto are genuinely scared of a bear market; Pitbull really did mark the top back in April. There are encouraging signs. Still, I have a feeling it will be all worthwhile.

Next time, I will try to pick a trade that takes less than 5 years to play out.