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Economic and Capital Markets Outlook

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The Great Financial Crisis of 2007-08 led to one of the sharpest contractions in economic activity and was accompanied by the largest drop in global stock markets since the 1930s. It is well known that the roots of the global financial crisis began in the United States. Perhaps less well appreciated is that its origins predated the 2005-07 boom in low quality mortgages and even the 2001-2004 period of low and stable interest rates which set the stage for the housing bubble. Still less well understood is the reason it became one of the worst recessions and financial crises in recent history: a confluence of overextended consumers, more reliance on non-traditional and largely unregulated forms of financing and a high degree of financial leverage.

As 5 years have now passed since the pre-crisis peak in economic activity and equity markets, we believe it worthwhile to re-examine both the origins and the unfolding of the debacle, in order to better understand how far along we are in the recovery process and determine prospects for financial asset prices. We believe that the recovery is unfolding along the lines we have expected and general progress continues to occur worldwide. We consider the historically low level of interest rates in the developed world to be the result of an exceptional policy response to exceptional circumstances. Bond yields are unsustainable at current levels and represent a poor risk-return opportunity. Equity markets, which trade at or below fair valuations and offer dividend yields above 10-year government bond yields across the developed world, are the more attractive asset class.

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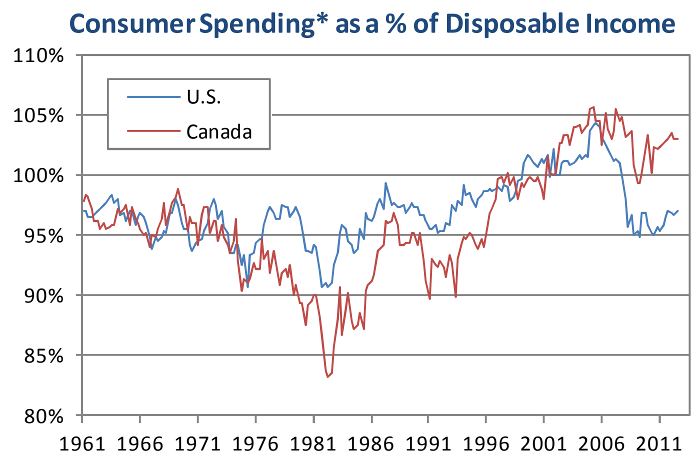
U.S. consumers live beyond their means

The story begins in the mid-1990s, when American consumers started to spend well above their average thresholds (Chart 1). Total consumer spending, including both personal spending and investment in housing, began to rise above its historical average of 97% of disposable income in 1993. In 1999, this measure breached 100%; for every after-tax dollar earned between 1999 and 2005, approximately $1.01 was spent on goods, services or housing. American consumers were able to sustain spending above their means through increased borrowing at relatively low interest rates and amidst an environment of easy credit. At the peak in 2005, total spending to after-tax income reached 104%.

Chart 1



*Spending on goods, services and residential construction
Source: Statistics Canada, Bureau of Economic Analysis

Between 1994 and 2007, disposable income grew 5.5% per annum while household debt increased by 6.7%. The expansion in debt mainly took the form of mortgages, which grew by 9.5%. Traditionally, mortgage credit was provided by banks and government-backed housing agencies such as Fannie Mae and Freddie Mac. As late as 2004, the market share of these conventional mortgage providers was 84% while new providers such as asset-backed issuers and specialty finance companies accounted for 8% of the market. By 2007, the market share of mortgages offered by the new providers had skyrocketed to 26%.

Financial innovation runs amok

The explosion in non-conventional forms of lending (the so-called “shadow banking system”) and the degree of overspending by U.S. consumers were two of the three main factors that exacerbated the eventual contraction in economic activity during the financial crisis. ABS issuers and finance companies, responding to investor demand for higher-yielding assets in an environment of relatively low interest rates, began to offer so-called subprime, Alt-A and Jumbo mortgages, many of which were packaged together in the form of tradable securities. These lower quality mortgages not only failed to meet the underwriting criteria of the traditional mortgage providers but were also financed directly on the bond markets, in contrast to the more stable deposit-funding model enjoyed by banks.

As borrowers began to default on the poor quality mortgages, a buyers’ strike developed, constricting the availability of credit to U.S. households. The non-traditional mortgage providers accounted for $640 billion of new credit to households in 2006; by end-2008, this sector had cut back $1 trillion in mortgages. The severity of the credit crunch brought many other financing activities such as auto loans, credit card receivables and equipment financing to a halt. The impact of the buyer’s strike was significant as about 40% of the $35.8 trillion total debt outstanding was funnelled through the shadow banking system.

Leverage magnifies credit crunch triggering recession

The economic impacts were felt very quickly. At end-2007, total spending represented 100% of disposable income; as spending on housing and non-housing related items contracted due to unavailability of credit and households' desire to improve savings, this ratio fell to 95% at March 2009. The impact on the financial markets was also significant. A crisis of confidence hit the banking system, once the extent of their exposure to mortgages of dubious quality came to light. In addition, the financial system and in particular broker dealers were operating at very high levels of leverage, with assets to equity ratios of 30 or 40 times. Just as consumer overspending and the importance of the non-traditional forms of financing were contributing factors to the severity of the recession, the high degree of leverage in the financial system exacerbated the stock market correction. These institutions were also hit by a buyer's strike; they were unable to attract financing for their short term commercial paper, difficulties also experienced by banks and other specialty lenders. All this pressure came to a head in the fourth quarter of 2008, following Lehman Brothers' failure.

Capital flight to Treasury paper, a complete freeze-up of non-government bond markets coupled with high leverage forced a multitude of financial players to liquidate portfolios. Falling prices begot more falling prices as margin calls were triggered. The S&P 500 Index peaked at 1,565 in October 2007 and reached its bottom of 675 in March 2009; U.S. stocks experienced a 57% drop, the sharpest correction since the Great Depression.

The "U.S. Calvary" comes to the rescue

The U.S. government, together with the Federal Reserve, enacted a series of measures intended to prevent a total collapse of the private market. The first order of business was to halt the liquidation of financial assets. The Fed and the U.S. Treasury created a multitude of programs to help finance banks and non-banks that were shut out of fixed income markets with the aim of easing the credit crunch. Secondly, the U.S. government passed a cumulative $955 billion in two stimulus packages to mitigate the contraction in spending by households and corporations. Third, the Federal Reserve cut short-term rates to 0.25% in an attempt to inject monetary stimulus into the mix by lowering borrowing rates. While the combined set of actions helped to stabilize the economy in 2009, significant damage had already been done. Real GDP growth was –3.3% year-over-year in Q4 2008 and –4.2% in Q1 2009.

The recovery process, is it different this time?

Given the scale of crisis, the deleveraging of the private sector and the need to correct government imbalances, we expected the economic recovery to proceed at a more moderate pace than past rebounds from recession.

Non-residential investment fell from a 2006-07 average of 11.5% of GDP to a low of 9.2% of GDP in late 2009 and started to climb back by mid-2010. Today, it has almost recovered to prior peak levels in dollar terms and accounts for 10.2% of GDP. Company profits have also staged a strong rebound: margins are close to peak levels and economy-wide profits are at new highs.

The housing market finally turned the corner in 2012, a full five years following the onset of the financial crisis. Housing starts are up 80% from the recession's bottom and up 40% from 2011. Starts are running at an 861,000 annual rate although this is still below the level of 1.5 million to 1.8 million new homes needed to satisfy a normalized demographic demand. Residential investment spending increased 14.6% from the prior year, housing prices are up 5% and the inventory of unsold homes is declining.

As noted earlier, one of the important policy measures to counteract falling private demand during the crisis was an increase in government spending. This led to massive government deficits, the size of which was last seen in World War II. Government deficits moved from 1.7% of GDP in 2007 to 4.8% of GDP in 2008 to 9.6% of GDP in 2009. A gradual cyclical improvement in government finances is taking place: the deficit is expected to be 7.7% of GDP in 2012 and given necessary compromises on the debt ceiling which will likely occur in first half of 2013, we forecast the deficit improving to 5.9% of GDP in 2013.

The U.S. is on the mend, and encouragingly both the economy and the financial system are on a stronger footing than in 2006. All major sectors of the U.S. economy are balanced, with the exception of the government sector where the adjustment process has a few years to run. Job creation continues at a moderate pace and consumer indebtedness is declining. The banking sector is better capitalized, credit is more readily available, the traditional broker dealer model no longer exists and the shadow banking system is a fraction of the size it was at the peak of the crisis. And yet short-term rates remain at 0%, long-term rates are at 200-year historical lows and the Fed recently relaxed its inflation target: more on this later.

Across the Atlantic, the crisis intensifies two years later

While European markets reacted in tandem with the U.S. given the strong financial linkages between European and U.S. banks, structural problems within the Eurozone did not come to the fore until well into the economic recovery. A few European countries, namely, Spain, Portugal, Greece and Ireland, as well as the U.K., a non-Eurozone member, had a household overconsumption problem similar to the U.S. The consumer spending adjustment in most of these countries began in 2007 and was mostly complete by 2010.

However, the impact of the crisis in Europe intensified in 2010. Given weak economic activity due to the contraction in consumer spending and residential investment and high levels of fiscal deficits, which grew as a countercyclical measure to the weak economy, foreign capital stopped being available to the periphery countries. A credit crunch took hold roughly two years following that of the U.S, but Europe’s crisis was amplified by the interbank linkages among creditor and borrower nations.

Excesses in Europe’s periphery financed by saver countries

Europe’s saver nations, Germany and the Netherlands, funnelled part of their excess savings to the borrowing countries of the periphery. Unlike the U.S., Europe remained reliant on the traditional banking sector: funds were channelled through the interbank lending market. Following Lehman`s collapse, the interbank market was in a fragile state as banks were uncertain of their competitors` holdings of toxic U.S. assets. But the uncovering of the poor state of the Greek government’s finances in 2010 led to a progressive shut down of interbank lending to banks domiciled in borrowing countries. Creditor banks now began to question the exposure on bank balance sheets to the debt issued by weak European sovereign nations.

As in the U.S., the European central bank had to step in to ensure the proper functioning of credit intermediation amongst banks within the Eurozone. The ECB enacted various policies to mitigate the credit crunch occurring in the periphery countries and restore confidence in the banking system. The credit crunch, together with cuts in government spending as European periphery countries were compelled to address their fiscal imbalances on a much shorter timeline than the U.S., Canada and the U.K., created a shallow recession in several European countries in 2012.

Much work to be done, but Europe on the mend

Europe is now on a more solid footing although the economy is likely to remain in a shallow recession in 2013 before returning to growth the following year. The Eurozone`s aggregate high saving rate has cushioned the impact of the contraction in economic activity. Periphery country excesses in consumer spending have been addressed and current account deficits are shrinking, lessening the need for cross-border capital flows. The banking system has increased its capital levels and the interbank market is functioning more smoothly, with the help of the ECB, as evidenced by the fall in Euribor (the reference lending rate amongst banks). Fiscal deficits are also slowly improving across the region. In aggregate, Europe`s current account is balanced and the region generates sufficient private sector savings to fully fund its government financing needs.

Canada escapes brunt of the crisis

Canada's experience following the Great Financial Crisis was quite different than that of the rest of the developed world, although Canadian consumers, like their U.S. and periphery European counterparts, had embarked on a decade-long trend of excessive spending (Chart 1). Given our strong economic ties to the U.S., Canada was inevitably impacted through trade and financial linkages when the crisis took hold and the economy fell into recession in 2008-09.

However, the Canadian banking sector avoided the large losses endured by major global banks in the U.S. and Europe. The combination of loose fiscal and monetary policy therefore proved to be quite effective in Canada. Lower interest rates allowed consumers to keep on borrowing and as Canadian banks were willing and able to lend, this allowed both consumption and real estate investment to remain at high levels. Fiscal stimulus fed into the economic recovery and employment rebounded quickly. The drop in economic activity was shallower and the Canadian government ran smaller deficits.

But is consumer's day of reckoning to come?

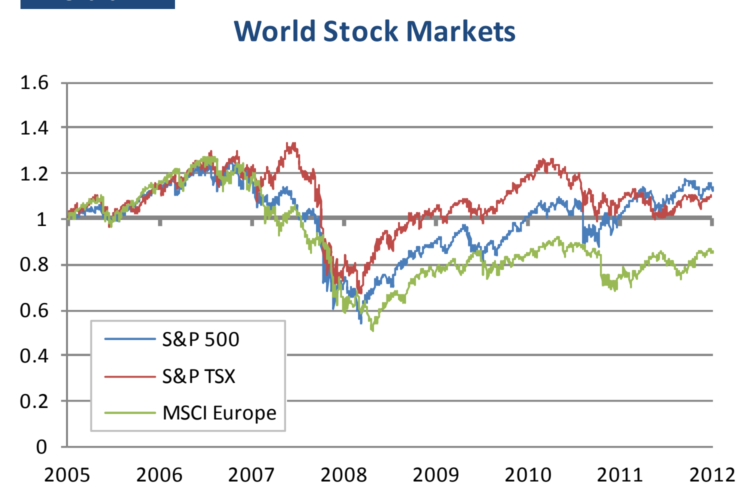
As all other developed countries have adjusted private sector imbalances during the past 5 years, it is startling that the Canadian consumer continues to spend at a rate of 103% of disposable income (Chart 1). Furthermore, Canadian house prices in aggregate are at a ratio of 4.8 times disposable income, compared with 2.7 times in the U.S. While the strong regulatory framework and the robust credit standards of Canadian banks suggest that a U.S.-style housing meltdown is unlikely to develop in Canada, this level of consumer spending is unsustainable. A gradual retrenchment towards the longer term average of 95% of disposable income suggests that real GDP growth in Canada is likely to be moderate, in the 1.5%-2.0% range.

Our New Year's growth forecast …

The global economy is still on the path to recovery, with developed countries in the process of addressing past economic excesses and developing nations largely unconstrained on their path to improved standards of living. In the U.S., we expect real GDP growth to be around 1.5% or better in 2013. A fiscal drag from higher taxes will moderate the growth in disposable income and household spending. Housing will grow as the sector normalizes while the trade sector should help foster economic activity. In Europe, the strong political will to continue to shrink fiscal deficits likely means that economic activity will remain flat or slightly contract in 2013, but a deep recession is unlikely given the reserve of household savings. Canada will experience similar growth as in the U.S. In the short-term, additional mortgage restrictions will slow the pace of borrowing, thereby forcing the Canadian consumer to rebalance its spending vs. saving equation. Globally, given continued growth in emerging markets, the IMF expects real GDP to expand 3.6% in 2013.

… and a wrap-up on financial markets

Chart 2



Note: In local currencies, Index: 2005 = 1

Global equity markets saw strong performance worldwide in 2012: in Canadian dollar terms, the S&P 500 was up 13.5%; S&P TSX +7.2%; DAX +28.7%; CAC-40 +20.0%; FTSE +11.9% and Nikkei +9.8%. While equity markets are significantly above their trough of March 2009, they are still below their prior peaks set 5 years ago while profits have set new highs (Chart 2).

Interest rates in Canada, the U.S. and selected European countries, however, remain below the levels prevailing at the depth of the financial crisis. This incongruous result has been the subject of much debate amongst investment professionals and we have devoted considerable attention to the current dislocation in bond markets in past Economic Letters.

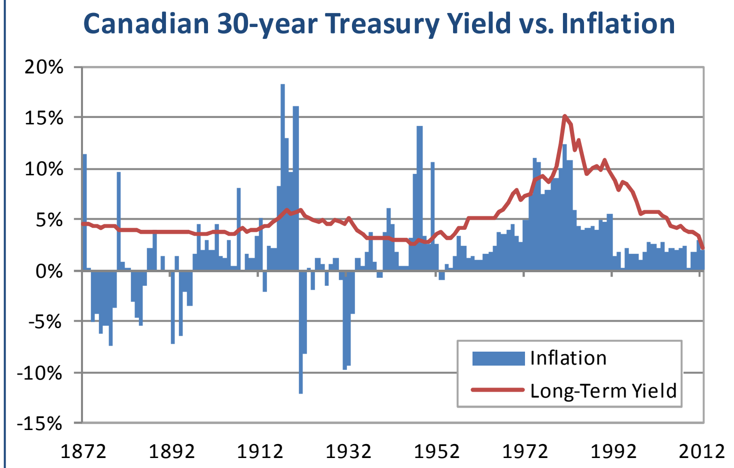
Exceptional times called for exceptional interest rate measures

As noted above, one of the critical steps central banks worldwide undertook to stabilize the financial system and stimulate the economy was cutting short-term rates. But the Fed has kept short-term rates between a target range of 0%-0.25% for the last four years. This together with successive rounds of Treasury (and Agency) bond buying has impacted yields further along the curve. For example, 10-year and 30-year U.S. Treasury yields averaged 3.05% and 3.65% during the thick of the crisis; at end-December 2012 these rates were 1.75% and 2.95%.

Furthermore, in a recent announcement, the Fed stated that rates will remain low until the unemployment rate falls below 6.5%. For the first time in its history, it specifically stated an inflation target of 2.5%. This represented a relaxing of its informal commitment to a 2% inflation target and suggests the Fed is prepared to experiment with higher inflation in favor of spurring faster economic growth. This is an experiment which, if the history of the 1970s-80s reminds us, can end rather badly for bond markets.

In Canada, despite a more resilient banking sector, less aggressive monetary policy actions, and a quicker rebound from recession, yields followed the U.S. path (Chart 3). Canadian 10-year and 30-year bond yields were 2.9% and 3.7% in Q1 2009, current yields are 1.8% and 2.4%. The Bank of Canada finds itself in a tough situation. On one hand, the central bank would like to rebalance the economy by slowing the pace of household borrowing; this would require higher interest rates. On the other hand, a strong inflow of foreign capital into Canadian bond markets strengthens the currency, thereby weakening exports and the economy as a whole. Any increase in policy rates is likely to accelerate foreign inflows, which is why the Bank of Canada remains on the sidelines.

Chart 3



Source: Statistics Canada, Homer & Sylla (2005), Lacey (1983).

But central banks may be sowing the seeds of next asset bubble

Albeit our rather sluggish 2013 growth forecast for developed markets, the recovery is progressing and economic imbalances are being addressed. Clearly as economic growth improves, the authorities will gradually withdraw monetary stimulus and allow rates to rise. We believe current bond prices in many developed countries are disconnected from economic reality.

After adjusting for inflation, rates at most maturities along the yield curve are negative in the U.S., Canada, Germany and the U.K. Investors will continue to lose purchasing power by buying and holding bonds which yield less than the rate of inflation.

In a search for yield in the current low interest rate environment, investors have not only ventured into longer-term maturities in safe haven countries but also towards lower credit qualities and bonds from developing countries. For example, spreads between U.S. Treasuries and comparable maturity high yield bonds are at late-2007 levels. The government of Mongolia (non-investment grade rating similar to Bangladesh) recently issued a US$ 10-year bond at 5.125%, a level similar to sovereign yields prevailing in Spain and Italy. Mexico, with a history of past crises and defaults, offers a 10-year Treasury yield of 2.8% on US$-denominated debt.

Investment conclusion: buy better valued asset

The risk-reward profile offered by Canadian bonds is poor. While pinpointing the moment the bond bubble begins to deflate has proven difficult, at current levels even small movements in interest rates will lead to capital losses. We therefore continue to maintain short durations and invest the majority of the bond portfolios in high quality government paper.

While equity markets staged an impressive rise in 2012, most major markets trade below historical fair value ranges of 14X to 16X price-to-earnings ratios. The P/E ratio based on consensus earnings forecasts for 2013 is 13.2X for the S&P 500, 13.2X for the S&P TSX and 11.8X for the Bloomberg Euro 500. We believe that company earnings will grow approximately in line with nominal GDP growth. Furthermore, most major markets offer dividend yields ranging from 2.5% to 4.5% which are at levels above prevailing 10-year bond yields. In this context, we continue to think that portfolios of carefully selected equities will outperform cash and bond investments over the next three to five years.

All dollar references in the text are U.S. dollar unless otherwise indicated.