June 2010

Another Chapter in the Global Deleveraging Cycle

The story began back in 1981, with a global recession brought on by high inflation and double-digit interest rates. North Americans were not spending. In fact, just the opposite – savings hit an all-time-high at 13% of income. As interest rates fell, savings decreased; consumption increased; and the economy began to grow.

Fast forward to 2006: after 25 years with only minor pauses in consumption, buying on credit had become a way of life for the majority. The official savings rate had hit an all-time-low of negative 6%; meaning that the average spending of families was at 106% of their incomes.

By the summer of 2007 problems had begun to appear with the riskiest loans, known as sub-prime loans. This would later prove to be the straw that broke the camel's back; but most investors ignored or were simply unaware of it. So that by 2008 mortgage delinquencies had increased to the point that banks had become fearful of lending to one another.

In order to stimulate the economy, U.S. interest rates were slashed to zero; and the U.S. government became a shareholder of Citibank, G.E. and G.M., among others.

By this time, the contagion had spread to European banks. England and Ireland, for example, also had to inject billions into their bank shares.

Governments around the world--from the U.S. to Europe, Canada, and China--embarked on massive stimulus-spending-plans in order to curtail their growing unemployment problems.

By the second half of 2009, investors had begun to gain confidence that the recession had ended, and increasingly abandoned their near-zero-percent savings accounts to return back to stocks. As of the end of April 2010, the Toronto Stock Exchange had gained 62% from its '09 low, its greatest yearly advance ever!

Unfortunately, this story of deleveraging has not ended. Governments soon realized that they did not have unlimited funds available. The Greek government, for example, with a budget deficit amounting to 13% of its GDP, found that investors were increasingly wary of holding its bonds--which plunged in value until bond-yields reached 16%. But Greece was unable to finance its massive deficit at this rate, and the International Monetary Fund (our tax dollars) and the Eurozone had to intervene to offer a bridge-financing bail-out, involving conditions of massive tax increases and spending cuts for the people of Greece.

In the most recent chapter of this ongoing saga, stocks lost roughly 10% during the month of May. Furthermore, recent data out of China suggests that a real estate bubble may be deflating there. One survey showed that property sales in Beijing tumbled more than 80% compared with the previous month.[1] Furthermore, The Purchasing Managers Index (an index of manufacturing) fell to its lowest level in a year.

The remainder of this story, of course, has yet to be written. However, I fear Canada will not be left out of it.

Canada has fared relatively well during this past recession. Real estate prices dipped briefly in early '09, but have since recovered to new all-time-record highs. Unsurprisingly, foreclosures and problem loans have remained remarkably low. Consumer spending surged in the first quarter of 2010, registering more than 6% growth, double that of the U.S. A recent report by the Certified General Accountants (CGA) Association of Canada, revealed the source of this spending. While consumer credit in Europe and the U.S. contracted, Canada's credit-debt has actually grown in the period since the recession officially began. In an interview with CTV news, Rock Lefebvre, Vice-President of Research & Standards at CGA, said "we were a little bit surprised that throughout the recession, we continue to take on debt."[2]

Findings of the CGA Survey:

Household debt in Canada reached $1.41 trillion in December 2009.
Debt-to-income ratio revealed a new record high of 144.4% at the end of 2009.
Borrowing through personal lines of credit increased 25 fold from 1989 to 2009.
Canada ranks first in terms of consumer debt-to-financial assets ratio among 20 OECD countries examined.
In 2008 and 2009, Canada relied to a much greater extent on borrowed funds when purchasing cars and renovating their houses than in previous years. By the end of 2009, Canadians borrowed 75 cents for every dollar spent on new cars, up from 39 cents in mid-2008.

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[1] Global Times – "Property sales plunge over holiday weekends" (May 4, 2010)
[2] CTV – "Canadians' household debt reaches record levels"

The two key conclusions from this survey are:

> "The amount of outstanding consumer credit per each dollar of consumption of goods has increased significantly, suggesting that households are either using increasingly larger amounts of credit to buy the same quantity of durable goods, or that households may have increasingly adopted a practice of using consumer credit for purchasing non-durable goods."
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> "The banking sector may suffer significant loss of assets rising from the troubled household sector."

The credit-dependence problem doesn't surface when a nation is accumulating debt; but it becomes quite evident when debt accumulation stops.

Every other nation has hit an economic wall while holding lower levels of household debt than our own. Canada's strong Federal balance sheet has allowed the government to subsidize bank lending, and thereby to foster further consumption, and more debt.

Mark Carney, the Governor of the Bank of Canada, however, has recently been warning Canadians about their high levels of debt: "Households need to assess their ability to service these debt obligations."[3] On April 19th of this year, mortgage-lending standards were tightened in an attempt to slow the tide of increasing debt. And on June 1 interest rates were increased by 0.25 percent.

Investment Strategies

Rising interest rates would be crippling to an overly-indebted household; and while the Bank of Canada did increase overnight rates by 0.25%, further increases may likely be minimal. So I continue to purchase Canadian dividend-paying preferred stocks with yields in the 6% to 7% range.

I will also continue to purchase U.S. dollars by exchanging them for my strong Canadian dollars. The currently strong economic data from Canada continues to impress global investors. However, since this strong data is primarily a function of debt-induced consumer spending, and since we are near the peak of Canadian household indebtedness, the Canadian economy will surely weaken significantly in coming months.

European and U.S. interest rates will likely stay extremely low for a long period of time. For this reason, consumer staples which pay solid dividends continue to look attractive. For the same reason, I continue to hold U.S. treasury bonds. I will look for a pull-back in price to add to holdings.

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[3] The Globe and Mail – " Carney urges prudence on debt" (December 10,2009)

There is an old saying on Wall Street: "Don't Fight the Fed." The U.S. Federal Reserve Board is the U.S. version of the Bank of Canada. So now that the Bank of Canada is removing liquidity from over-leveraged Canadian consumers, I believe it's time to take proactive steps: the Canadian economy, stock market, and currency could well disappoint investors.

Sincerely,

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