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Tom Bradley

Staying Calm in the Calm

When I was in Toronto a few weeks ago, I was walking north on Bay Street toward King and was struck by how quiet it was. It was probably just a lull in the day, but I couldn't help but feel it was analogous to where we are in the capital markets. Things are calm and subdued.

Why would the epicentre of Canadian finance be so quiet, literally and figuratively? It's obvious I guess. Markets are going up and clients are happy. Volatility is nowhere to be seen. And the few political/economic blowups we've had, like Ukraine and Iraq, have had little impact on market prices.

This all seems pretty good and you'd think a guy who carries the handle "steadyhand.calm" would be embracing the tranquility, but as with many good investors, I'm skeptical. When investing gets easy, I get nervous.

My anxiety focuses on two areas – complacency and lack of a safety net.

Complacency

It feels like investors have become complacent about – well – everything.

The strongest consensus I've seen in recent years relates to low interest rates. The rationale is, rates won't go up because we can't afford it. A question from a client last week embodies this view. He asked, "Can interest rates actually increase?"

Related to rates is an increasing comfort with debt. Carrying costs are low and families are okay with heavily leveraged balance sheets. Instead of, "How fast can I get my house paid off?," the question is, "Should I get an investment loan to go with my mortgage, home equity loan, credit line, car lease and credit cards?"

It follows then that Canadians are confident that house prices will stay high.

So why my concern? A piece in The Economist captured it well. It referenced the late Hyman Minsky, an economist who argued that long periods of stability are ultimately destabilizing. "When assets are less volatile, buying them with borrowed money seems safer." It went on to say, "This briefly enhances stability, by enabling consumers to keep spending, even when their incomes take a hit. But the build-up of debt raises the risk of a far more violent crisis and recession – especially if, as now, there is little room for central banks to cut interest rates."

No cushion

The article refers to my other source of concern. We are operating without a safety net. In times of economic and market stress, we normally get relief from two stimulants – lower interest rates and increased government spending.

Unfortunately, we're using up the first pill in "less-than-stressful" times, as governments try to recapture the growth and employment glory of past cycles.

As for spending, the appetite and capacity is not what it normally would be after four years of recovery. Most governments are still wrestling with their previous binges, or at least politicking about it.

There's also little margin of safety built into valuations. With bond yields edging down this year and inflation gaining momentum, real interest rates (adjusted for inflation) are again approaching zero. The 2.3 per cent yield on a 10-year Government of Canada bond is right in line with the latest inflation numbers.

The extra yield from owning riskier income vehicles is also on the skinny side. The spread on corporate and high yield bonds is modest and capitalization rates on income properties are extremely low.

Over the past two years, the move in the stock market has largely been driven by rising valuations. Price-to-earnings multiples have gone from below historical averages (low teens) to above (mid to high teens). P/Es are not extreme, but in my view, they have more room to go down than up.

Bank of Canada Governor Stephen Poloz captured the safety net issue well. He was talking last week about the Canadian housing market, but his comments apply to the capital markets in general. He said, “It’s like if the tree in the backyard has a crack in it, you worry it’s vulnerable to a storm.”

Things can stay good for a while, but we need to be careful what tree we take shade under. Faux stability will translate into real volatility as sure as there is wind and lightning.

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