February 23, 2016

This is not the Great Recession 2.0

In January, we reminded our clients that all markets tend to normalize or mean revert over time as financial stresses ease. We explained that the current market correction will be followed by a market recovery, just as such events have unfolded in the past.

Today, we explore several ways in which the current global economy is in much better shape than it was during the Great Recession of 2008-2009.

In 2016, economic growth is lower than normal, commodity prices have corrected sharply, and corporate profits are soft. We see this situation as part of a typical economic cycle. Conversely, in 2008-2009, the global financial system was facing a serious and fundamental threat to its viability. The situation was outside the bounds of a normal economic cycle.

The story in 2008-2009

Between its peak in May 2008 and its trough in March 2009, the S&P/TSX Composite Index fell 48%. In the U.S., the S&P 500 Index fell 53% in U.S. dollars from its peak in October 2007 to its March 2009 bottom.

The financial system in the U.S. was at a risk of collapse because of sub-prime mortgage problems. Banks had sold mortgages to borrowers with poor credit histories and then insured the mortgage risk through other financial institutions, which then repackaged the mortgages and offloaded them to other financial institutions. These counterparties used these investments as the cornerstone of their stable capital base.

These transactions worked very well while house prices were increasing. When house prices stopped rising and mortgage defaults began increasing, banks were unable to recover their mortgage principal values upon foreclosure. As losses spread, more and more financial institutions – especially the ones that bought the repackaged mortgages – teetered on the brink of financial collapse.

The impact of this shock was extreme. As tightened mortgage lending regulations took hold, the real estate market correction became more acute. This situation created more instability among financial institutions. Due to the stress on bank financial statements, bank lending receded, resulting in financial difficulties for many companies seeking to renew existing loans. At the same time, heavy personal debt loads, combined with spiking unemployment levels, contributed to a significant drop in consumer spending.

Despite the U.S. origin of the mortgage crisis, the significant investment in these complex mortgage-backed investments by non-U.S. financial institutions spread the financial contagion outside America. As a result, global GDP growth slowed significantly in 2009.

A modern industrial economy needs strong and stable financial institutions. The U.S. government and its central bank launched unprecedented massive stimulative measures to bolster the financial system and a major crisis was averted. It is important to note that while Canadian banks' stock prices corrected with other global financials, Canadian bank earnings were not as strongly impacted and their balance sheets remained sound throughout this global crisis. Their relatively small exposure to U.S. sub-prime mortgage loans was a major factor in this relative outperformance.

The story in 2016

Between its peak in September 2014 and the lows of January 2016, the S&P/TSX Composite Index fell 21%. The S&P 500 Index fell 13% in U.S. dollars from its peak in May 2015 to its low in early February 2016.

Global economic growth, despite being slower than it was prior to 2008, remains well above 2008 crisis levels. The January 2016 Update from the International Monetary Fund (IMF) projects the global economy will grow by 3.4% in 2016.

The cause of the current correction was a drop in Chinese economic growth and an accompanying fall in the demand for energy and materials. This situation was exacerbated by a tightening of liquidity and the expectation of higher U.S. interest rates, which caused the U.S. dollar to rally significantly. The result was a sharp sell-off in commodities.

Courtesy of Bloomberg, here are just a few examples of commodity price declines in 2015 in U.S. dollars:

- Crude oil, down 36%
- Iron ore, down 37%
- Copper, down 25%
- Potash, down 19%

Many investors believe that the commodity correction is signalling a major worldwide economic slowdown. While the economic situation in 2016 is serious, we believe it is not nearly as worrisome as the 2008-2009 global financial crisis.

The current financial concerns tend to be more localized. They emanate primarily from the energy and resource sectors. The concern is that low energy and commodity prices will result in bankruptcies in the commodities sector and will, in turn, spill over to other parts of the economy.

While low commodity prices have negatively affected non-commodity segments of Canadian and foreign economies, we believe the impacts are consistent with a normal cyclical downturn in resources:

- The IMF projects Canada's GDP growth to be 1.7% in 2016.
- Unemployment levels remain well below 2008 levels in North America and globally.
- Banks remain better capitalized. Canadian bank debt exposure to commodities companies remain manageable even under our worst-case stress testing analysis.
- Global financial institutions remain better capitalized than in 2008, despite lingering fears over European banks.
- Outside the U.S., central banks are operating decisively and in concert to moderate the impact of the short-term strains.

We believe that the severe short-term stock market and credit market correction reflects an overreaction by jittery investors who still remember the extreme market shock of 2008-2009.

Moreover, we believe that the supply surplus in the energy market will eventually reverse as growing demand for oil and slowing North American production relieve this temporary imbalance.

In conclusion, the situation in 2016 is different from the one in 2008-2009. The global economic system is in better shape. In Canada and elsewhere, we see excellent opportunities to buy quality companies at prices that haven't been this attractive in years.
