

What's next in the credit crunch?

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It's been a tumultuous August as an upheaval in credit markets spilled into the broader stock market and sparked concerns about the global economy. On Tuesday alone, the Dow tumbled 280 points while the Canada's benchmark index shed 222 points. Is the worst now over, or does more turbulence lie ahead?

Three experts from the financial world offer their views.

Sébastien Lavoie, economist at Laurentian Bank of Canada in Montreal

"The wave of announcements of exposure we're currently experiencing is not over. As we know, the non-bank Canadian asset-backed commercial paper is a huge market, estimated at about \$35-billion, and I expect more firms to announce their exposure over the next few days and weeks.

"So the roller coaster ride is not over. It's not yet time to let out a sigh of relief. And there's no sigh of relief at the Bank of Canada either. As we saw at the speech last night of deputy governor Pierre Laguard, basically the bunch of economists at the Bank of Canada are trying to assess properly the impact of the credit crunch on the Canadian economy.

"It's definitely a bit more worrisome now than it was just a few weeks ago. My feeling is there's more weakness in the armour of the U.S. and Canadian economies and more ways of contagion. The economy now and over the next few months, appears to be more subject to fragility than a few months ago.

"This might lead to weaker consumption and spending growth [in the U.S.]. I expect at best in Canada moderate growth for the rest of the year and in the U.S. it's more slow growth.

"The risk of a U.S. recession have increased rapidly. At the beginning of August, I believed it was one chance out of six by the end of the year. Now it's more one chance in three. Which still means it's not the most likely scenario ... but this is a serious risk, coming from the credit crunch.

"We will get more bad news on [the U.S. housing market] before it gets better. There's a risk that the mood of the investor will [worsen] quickly again because we'll get more bad news on the housing front. We expect more foreclosures, more renewals at higher interest rates and on top of that we'll start to see much weaker growth in employment.

"What's going on in the U.S. will obviously affect exports and that adds to all the other challenges we have like the elevated loonie. The other channel is through the exposure of firms that invest in ABCP and that will come up ... they could possibly slow down hiring intentions, try to restrain spending and that means less employment growth.

"I'm definitely more worried than I've been since 2001. We're right in the middle of the storm right now."

Wilfred Hahn, money manager based in British Columbia, who runs Hahn Investment Stewards and was formerly head of Royal Bank's global investment group

"One of the smallest probabilities is one that assumes things get back to normal, normal being probably ... the environment we experienced in the first part of this year — a lot of leverage going on, high confidence, low risk spreads and so on. Low odds are that we're going to get back to that any time soon. The highest probability scenario that we see is we're going through a gradual de-leveraging process. If that's what it is, then we're not through the totality of the change, there's going to be more volatility and more downsides. It's the nature of the beast right now. So, it's too early to jump back in the water.

"There are broader consequences. We did have a crash — it was not a crash in the stock markets. We're all conditioned to think about financial markets in terms of what stock markets do, it was just a minor tremor. But there was a real crash in credit systems, it was and is unprecedented and scary. The unwinding there continues, and we are looking at a very different regime and impact's going to happen. Then we'll see more impact on stock markets, corporate earnings and economic growth, that will play out later. There are real economic impacts that will flow out of the monetary credit crash that we've seen.

"Quite frankly we've anticipated tougher times, we had very high cash levels, we identified high levels of risk and we haven't jumped back in. We have a lot of things on our monitoring list, and right now we just think it's way too early to spend our money. There are some interest-type vehicles looking very cheap, but if some of the real-life economic impacts a quarter or two down the road come back to bite us, some of these things might even get cheaper.

"There are opportunities out there but we're certainly not going to be taking down our cash levels. It's much too early.

"Things are a little more robust in Canada than they are in the U.S. We don't have subprime issues, but Canadian households aren't necessarily in much better shape than the American ones. It's a global [shift] because it's affecting all kinds of credit structures including leveraged buyouts. That won't be as prevalent for sure.

"So much of the credit system we have

today is not banking related. It's not the system like in 1987, back in the last crash ... at that point then central banks had much more leeway. Now it's the non-bank system that's an enormous provider of credit, and that doesn't have access, directly, to central bank actions. Those are all playing into this right now."

Juliette John, lead manager of the Bissett Dividend Income Fund in Calgary, which has \$981.2-million under management

"Capital markets may experience further volatility however market swings may unearth some good buying opportunities for fundamental investors.

"As bottom-up investors, we have not let the macro events influence our decision-making; however, the declines have made some sectors more attractive. The strong capital bases of Canada's big banks put them in good stead and in many ways they are more conservative than their U.S. peers.

"It is worth noting that Canadian sub-prime lending is very different than in the United States. First, there is no interest deductibility for mortgage interest meaning that Canadians have not had that tax-related incentive to borrow. Second, U.S. borrowers aggressively refinanced mortgages, extracting equity from their homes to maintain consumer spending habits while it remains more costly and there are more restrictions in Canada to refinance a mortgage. Third, domestic lenders have not sacrificed their lending standards and have a better equity cushion in terms of loan-to-value ratios on outstanding mortgages. Fourth, Canadian lenders have not relied on securitization to the same extent in order to fund loan growth.

"Canadian companies have enjoyed more than four years of double-digit earnings growth and while the Canadian economy remains sound, headwinds such as the strong dollar, declining earnings momentum and a possible ripple effect from the weak US economy could negatively impact Canada in the coming quarters.

"It is also possible that credit remains much tighter than it has been over the past few years. This may make it more expensive for private equity players relying on the leveraged buyout structure to make acquisitions. If the leveraged buyout cycle has peaked, so too might the speculation of takeover activity and the related inflation of valuation multiples.

"August through October tend to be the weakest months for investing and 2007 is turning out to be no exception. We urge investors to focus on their long-term objectives and less on the short-term gyrations of the market."

(Comments have been edited for length)