THE GLOBE AND MAIL

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A 60-cent loonie and painful days for banks and homeowners: predictions for what comes next

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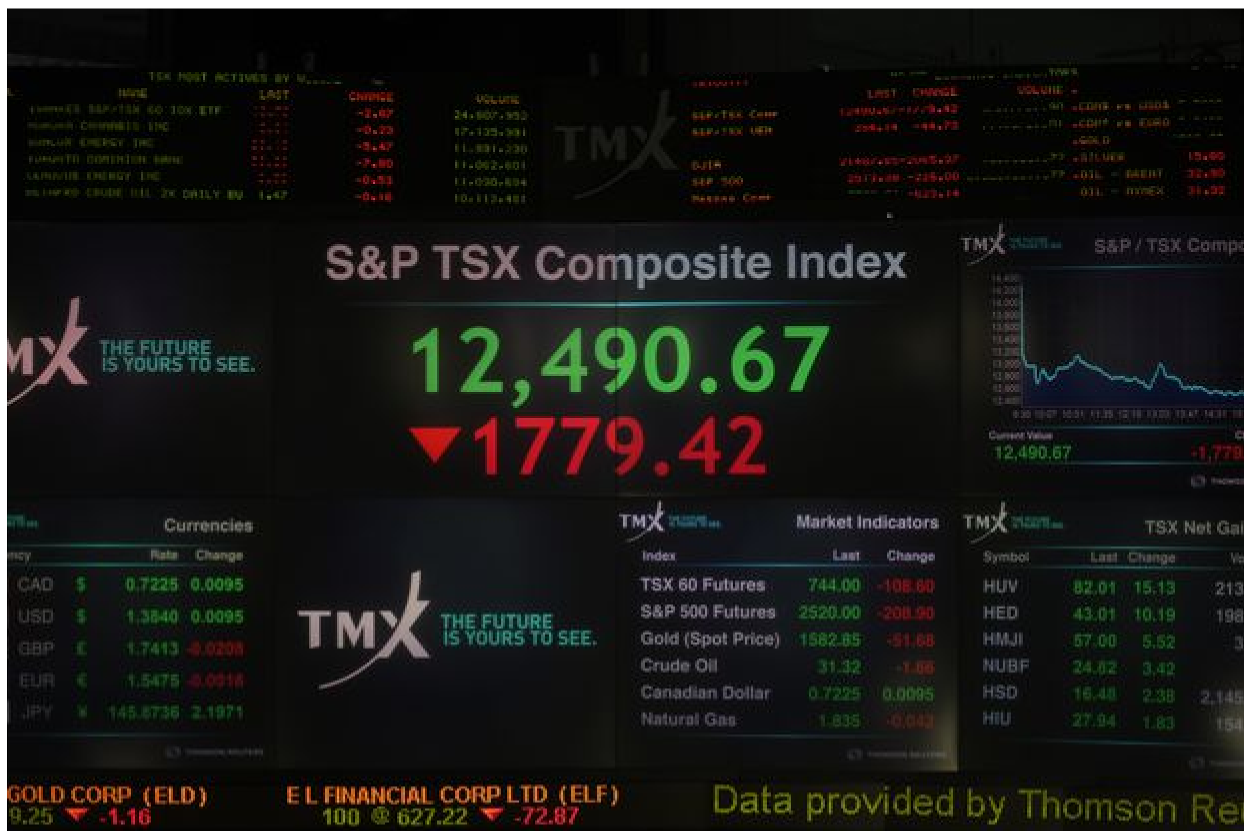

The S&P TSX Composite Index screen at the TMX Broadcast Centre in downtown Toronto is photographed on Mar 12 2020.

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We are about a month into the market turmoil from the pandemic. From week to week, the markets seem to go back and forth between panic and blind optimism.

Stocks sharply rebounded from their lows. Yes, our successes in fighting the COVID-19 pandemic are building; and yes, governments have been quick to deliver support. But for the investor, what lies ahead?

Getting back to “normal” within a quarter or two – the so-called V-shaped recovery – seems to be quite a long shot and a vaccine sounds as if it is still a long way off in 2021.

Unlike the Chinese economy, which is much more dependent on manufacturing and exports, the North American economy relies heavily on domestic consumers and business services. It’s one thing to get back to work, quite another to get businesses and consumers spending again.

The COVID-19 crisis is not like 2008-09. The financial crisis was a Wall Street problem that became a Main Street problem in the United States and then spread globally. The COVID-19 crisis is happening everywhere at once and Bay Street and Wall Street are playing catch-up to try and adjust.

During a typical economic crisis, we might expect gross domestic product to contract by a few percentage points in a given quarter. In 2009, when all was said and done, real U.S. GDP declined by 3.1 per cent for the full year, while Canadian GDP fell by 2.5 per cent.

This time the contraction is likely to be much more severe. Businesses are not facing normal, recessionary declines. Rather, they are facing a drop from 100-per-cent operating capacity to 70 per cent, or 50 per cent or even zero per cent. The resulting disruption is, therefore, more like a Depression-era correction than the downturn of 2008-09.

Governments have committed to massive bailout packages, which are certainly positive in the short term. But job losses are likely to be staggering. By May, some estimates have the U.S. losing more than 25 million jobs, representing a peak-to-bottom decline in employment of 16 per cent in three months. At the bottom, the U.S. lost 6.3 per cent of its jobs in 2008-09, and that took 26 months to play out.

The bailouts will also come at a substantial cost to taxpayers in the longer term. In Canada, all forms of debt – consumer, corporate and government – were already at record levels before the crisis, with Canada’s precrisis public and private debt-to-GDP already more than 300 per cent.

Further government borrowing, coupled with the need to keep Canadian interest rates low, combined with a collapse in commodity prices, is a recipe for a dramatic correction in the Canadian dollar. We expect the Canadian dollar to fall toward 60 US cents, with a growing risk that our national debt could face a downgrade from its prized AAA rating.

The three critical sectors for the Canadian economy are housing, banking and energy. All three face significant pressure.

Why Canadian housing could be in trouble

Typically, in an economic slowdown, there is an initial decrease in listings as homeowners are reluctant to move or list in a weak market. However, as demand falls and houses remain on the market longer, oversupply begins to build.

What happens next depends on whether financially motivated sellers enter the market, including those who have lost their jobs and those that can no longer afford their oversized mortgages.

At the end of 2019, the ratio of listings to Canada’s total housing stock stood at a historically neutral 5.1 per cent; roughly one out of every 20 homes was on the market. It wouldn’t take much to trigger an imbalance – just one or two more homes per 100. In 1990, for example, the ratio hit 7.1 per cent, triggering a price correction that took some 13 years to reverse.

Today, we have a much higher share of foreign-owned and investor-held properties, with the risk that these owners may liquidate into an already thinly balanced market.

Canadian banks are unlikely to be spared

Consumer and corporate insolvencies are likely to rise significantly, even with government bailouts. As a result, the tremendous run of earnings growth at Canada's Big Six banks is likely over.

In the short term, the Office of the Superintendent of Financial Institutions plans to allow loan deferrals to be treated as performing loans, but that just pushes out the problem. Eventually, the banks will have to swallow significant loan losses. As they do, profit margins will come under pressure, leading banks to cut costs, which means job losses.

We're still in the early days of the crisis, but there is shakeout brewing.

Energy is down, but more pain is coming

With energy demand destroyed by COVID-19 and the struggle of OPEC+ to respond, the highest cost, most indebted producers will go bankrupt. Less drilling will tighten supply, which should support oil prices over time, but any rebalancing of the market depends on the strength of the eventual recovery. In the meantime, North American production will drop, reducing the call on infrastructure such as pipelines.

Investors should tread very carefully as only companies with very low costs and ironclad balance sheets will survive.

Invest, don't speculate

It is time for investors to retire the buy-the-dip mentality and instead focus on buying well-run, undervalued companies.

Be prepared for at least two quarters of terrible news and financial results and for consensus earnings numbers to drop sharply. Remember, all companies are only as strong as their customers, so keep an eye on how downstream businesses are doing.

The most important thing to remember is that the fallout from this pandemic will not last forever. We will come out on the other side, but it is good, rational analysis that will get us there.