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THE END OF AN ERA

The decision by authorities around the world to recapitalize their banking systems by injecting capital directly into those banks deemed to be too big to fail marks the end of an era. The process of deregulation and reliance on market forces, while central banks and regulators either ignored increasingly risky behaviour or actively encouraged developments that they agreed with philosophically was emphatically buried when US Treasury Secretary Henry Paulson, ex CEO of Goldman Sachs, one of the investment banks that had been the biggest beneficiaries of the process, appeared before the nation on live TV this week. He apologized for the various sins of omission and commission that had led to the eruption of the credit crisis, while explaining how much he, as a strong believer in capitalism, was distressed by the necessity of the government becoming a major shareholder in the nine largest US banks. There had been no argument about whether they accepted the offer either. In what has been described as a Don Corleone moment, even those banks which felt their capital position was secure enough not to need to issue the government preferred shares paying 5% and accept restrictions on management pay and dividend payments were told this was an offer they couldn't refuse for the health of the US (and global) financial system.

This followed on from the final passage of the U$700bn Temporary Assistance Relief Package (TARP) which had finally made it through the US House of Representatives, albeit only after the addition of liberal quantities (estimates ran up to U$150bn extra) of political pork applied to persuade Representatives to change their vote. U$250bn of the U$700bn has now been used to directly increase the capital of the banks. Ironically, the US was following in the footsteps of the UK, which had been the first country to see serious effects from the tightening of credit markets a year ago in September 2007 with the run on the bank and eventual nationalization of Northern Rock. Having been criticized for a lacklustre and slow response to the spreading credit crisis, which saw another former building society (savings and loan) Bradford and Bingley, have to be nationalized and the country's largest mortgage lender Halifax Bank of Scotland (HBOS) forced into a shotgun marriage with LloydsTSB the UK was the country that made the most aggressive and successful move to address their problems and has been the model that other countries such as the US, Germany and France have followed. The British response in the week of October 6th was to not only guarantee short term bank debt, increase the amount of customer deposits that were guaranteed and inject massive quantities of liquidity into the markets, but also make direct investments of up to U$67bn in their major banks, Royal Bank of Scotland, Halifax Bank of Scotland and LloydsTSB.

This combination of measures stemmed the mounting panic in the stock markets after the failure of an unprecedented co-ordinated cut in interest rates of 0.5% on Wednesday October 8th by the US Federal Reserve, the European Central Bank, the Bank of England, the Bank of Canada and the Swedish Riksbank to stem the tide of liquidation that drove all stocks, good, bad and indifferent down on massive selling. The rout culminated with all countries' major indices down 18-22% in that week, and 40-45% over the last year, including Canada. When the emergency meeting of the G-7 finance ministers and leaders in Washington over the weekend of October 11-12th followed the British example, some stability returned to markets, with the largest ever one day rise in the Dow Jones on Monday October 13th, and the second largest percentage rise in the S&P500, followed after the Thanksgiving holiday, by a similar 9.8% rise in the S&P/TSX. The market has displayed unparalleled volatility over the last two weeks, with the "fear index" or the Chicago Board of Trade Index of Volatility (the VIX), hitting all time highs on Thursday October 16th that had not even been seen on Black Monday in October 1987.

Where does this leave investors after what has undoubtedly been the most tumultuous few weeks in post war financial history? The first point to emphasize is how well the Canadian financial system has stood up to the extraordinary pressures of the credit crisis. No Canadian bank has required government assistance and only one, CIBC, has had to resort to making a $2.9bn equity issue. While the collapse of the Asset Backed Commercial Paper (ABCP) market last summer was a home-grown Canadian crisis caused by poorly drafted loan agreements, the Montreal accord has ended up with the situation resolved to the satisfaction of over 98% of the holders of ABCP, and Canadian banks willing to stand behind products they helped market. No Canadian money market fund has "broken the buck" or failed to repay 100 cents on the dollar to investors. The Canadian government has provided liquidity to the market by offering to purchase $25m in mortgage backed CMHC securities off the banks to free up their balance sheets but has not needed to guarantee short term bank borrowing or inter bank lending and the deposit insurance remains at $100,000 per account without any necessity to increase this level of guarantee.

In part this reflects the much greater strength of the Canadian economy, where property prices were rising until recently and even now, are only down around 5% in the more inflated centres like Calgary and Vancouver, not 16-20% as in the US. Canadian commercial property is also in good shape, reflecting the much stronger economic growth in Canada, particularly those areas exposed to the resource sector. While industries such as auto makers and auto parts exposed to the US Big 3 companies have been suffering, as has the forest products sector, hurt by the softwood lumber dispute and then the collapse of US housing, those Canadians who wish to find work and are willing to move are still able to do so, as evidenced by the 30 years lows in the unemployment rate of 6.1% and the 107,000 new jobs added to the workforce in September. Inevitably the US and global slowdown will have some further effect on Canadian economic activity, but the emerging middle class of China, India and the other emerging economies will not stop desiring and demanding the middles class lifestyle that they see the developed economies enjoying. These countries are now the price setter for commodities as they are by far the largest user of many industrial commodities and the source of almost all the growth in demand for oil, gas, coal uranium and food. The recession now enveloping the US and Europe will not lead to the same sharp downturn in commodity prices as previous recessions, as the prices are now set in Shanghai and Mumbai, rather than Chicago and Frankfurt.

Lastly the importance of conservatism in finance cannot be over emphasized. The Canadian banks have been criticized for their unwillingness to embrace the more exciting financial innovations with the same enthusiasm as their US neighbours and the bank of Canada was regarded as old fashioned with its insistence on maintaining lending standards in the mortgage market. You may recall David Dodge, when Governor of the Bank of Canada, writing an open letter to the CMHC when it started insuring 35 and 40 year mortgages and reduced the size of the down payments to enable potential homeowners to afford houses that were rising in price. He warned about the possibility this relaxation of standards could encourage people who should remain as renters to stretch themselves to buy a home they might not be able to afford. Canadian banks' losses, including the U$7.9bn incurred by CIBC, only total U$11.6bn as at end September, less than 1.6% of the $649bn that banks worldwide have had to write off in the last 15 months. One only has to contrast the position of strength which the Canadian financial companies now occupy to see how well their own restraint and a strong regulator have served them.

Of the current recommendations made in the financial sector in Income Investor all of which, with the exception of Power Financial, have been made in the last year or so, just about the worst time to have initiated a position in the financial sector, Bank of Nova Scotia has performed best, with a total negative return of -12.3% from end September to Friday October 17th, Power has a negative return of -24.6% and Davis + Henderson the cheque printer is off -25.3% including the distributions all over the same period.. Interestingly all of these have outperformed the S&P/TSX Index off -30.3% in the same 12 and half months (including dividends), and only Sun Life, down -36.8%, has done worse, reflecting the view that life insurance companies are a kind of warrant on the equity markets, when a majority of its investments are in fixed income.

In fact, the end of the era of rapid expansion, of the relaxing or disappearance of lending standards and the belief that any loans made, however bad, could be wrapped up, given a credit rating and sold to yield hungry investors will leave US and European banks looking a lot like the Canadian banking industry, except that their shareholders will have been diluted by their government bailout, had their dividends restricted or removed and seen their share price perform much worse than the Canadian banks did. Investors should be purchasing Canadian financials and will end up being rewarded over the next couple of years.