

THE LIQUID State

As markets search for bottom, Teachers' Andrew Spence says liquidity is the best medicine

BY CAROLINE CAKEBREAD

There may be some good value out there, but we have yet to hit bottom, says Ontario Teachers' Pension Plan chief economist Andrew Spence. In this interview with *Canadian Investment Review* he talks about the financial crisis, his outlook for global markets and whether or not it's possible to prepare for black swans. The answer—it's all good if you're able to stay liquid.

In your view, what are the implications of the financial crisis and when do you see things improving for financial markets?

All financial crises begin with the failure to provision for liquidity on the part of the financial sector. Why? If you remain liquid you're basically earning T-bill returns and many pension plans face hurdle rates well above prevailing levels of risk-free interest rates. To earn more than that you need to take risk. For example, if you were a global investment bank, your target was a 25% return on equity, which for a relatively mature business when inflation is 2% is a very large return hurdle. Ultimately banks were forced to take bigger risks than they otherwise would to meet high targets, and they had to pull away from liquidity sequentially. When the shock finally hit, there was insufficient liquidity in the system. Central banks responded by expanding their balance sheets to try and make up for the fact that private investors all of a sudden were not prepared to supply the appropriate liquidity to the system.

The second issue we saw in the wake of Lehman Brothers was that demand for liquidity was so tight that people were forced to sell assets—any asset they could at any price to bring liquidity. This is why we saw such a sharp and aggressive sell-off through November.

Markets have since stabilized—central banks have

managed to get sufficient liquidity into the system to make sure that at this point we don't have to have forced sales of assets. Central banks have dealt with the liquidity issue but bond spreads remain extremely wide, and credit markets are not functioning well. Those markets that are being supported by central banks around the world are doing better than the markets that aren't. But it's fairly safe to say that unless you are an extremely high-grade corporate, it's very difficult to issue paper in the credit markets.

Then we come to the banking system itself. It seems to be broadly insolvent across many countries—there's bad debt in banks everywhere and regulators should seek to achieve full transparency of actual losses in order to maximize credibility and resolve this issue. These assets have to be marked down to the point where they are below the notion of expected economic value so that only upside potential now exists. That would mean separating good banks from bad banks and there would have to be a well-orchestrated workout of the banking system—which to keep, recapitalize and removal of bad debt. The banks that are beyond saving would be shut down. The government would take down that debt and work it off slowly over time. We are getting to that point but until we get there, the full restoration of the banking system's ability to lend will be hard to achieve.

Moreover, secondary credit markets will be hard to restart completely. The system needs private individuals to stop hoarding liquidity and to be prepared to earn more than 10 to 12 basis points in any three-month period. We're not there yet. So to my mind there is no compelling reason to say equity markets will come back quickly or that credit spreads are going to come in until that is achieved. Governments and central banks are working towards that but it takes political consensus and leadership to be successful. The U.S. is getting there

this year and is talking about what they have labelled an aggregator bank to collect the bad debt, take it out of the system, and remove once and for all the downside uncertainty, allowing risk taking to restart.

However, today's bad debt is highly complex—heterogeneous securities make it hard to price. So even if we get to the good bank/bad bank model, which is where we seem to be going, the procedural difficulties are immense and will not lend themselves to a quick repair. My guess is it will take a lot of time for asset markets to buy into a program that will render a final resolution to this. And it will also take a while for the economy to recover. The world is in a period where growth will be very weak—economies are still shrinking and that will continue into the middle of the year. It won't be until the second half of the year that economies stabilize and subsequent growth will be very slow as the systems work off the legacy of these excesses.

Do you think we are at the bottom of the equity market or close to it? Why? Why not?

The problem we've got is that nominal GDP growth everywhere is going toward zero and could even dip below zero—we have not seen that in the postwar period in most countries. Earnings of companies are related to overall economic activity. Earnings are going to come under severe strain in the next year, so it could well be that as earnings drop and prices don't change—a price-earnings (P/E) of nine for Germany could easily become a P/E of 18. Then the German market, for example, doesn't look quite such good value—I think there's significant dissonance between the pricing of equity markets and what will actually happen to earnings in the year ahead. If you are thinking of entering the market now to capture value, you need to hunt for those markets with extremely low P/Es so that even if earnings do fall and the P/E doubles, it's still good value. Only a handful of markets offer that reward. We are close to the bottom but I'm not sure it's established.

Will Canadian Equity markets do better than U.S. equity markets in 2009?

Canada looks better-priced than U.S. markets, from a P/E perspective. Not much, but a little bit. Canada's market is heavily concentrated in natural resources and the banks. And the Canadian banking system was better regulated, so they were somewhat shielded from the impact of the worst excesses because we did not indulge in them. However, Canada still has a very high traded share of gross domestic product (GDP) and if there is a big interruption in demand

from south of the border, that will hit us hard. The banks will be in receipt of loan losses through the next 18 months or so despite being well-capitalized. It's very hard to see a recovery in commodity prices of any magnitude in the next 12 to 18 months. Consequently I find it very difficult to see how Canada can outperform the U.S. in an environment like that.

How might calls for renewed infrastructure spending impact on the performance of alternative asset classes?

When we, Teachers', think of infrastructure and so-called alternatives we think about these assets as hedging our liabilities. Our liabilities are mostly inflation-indexed so we look for assets that both give us a degree of protection against inflation but that also give us a higher real return than is available from index-linked bonds. Infrastructure fits that definition but we have in mind mostly mature infrastructure enterprises that are operating rather than development projects—toll roads, for example, as the toll goes up in line with inflation we get the inflation protection plus the return on capital for investing in that business investment. These so-called shovel-ready projects are development projects and that's not really what we have in mind with respect to an infrastructure asset that hedges the liabilities.

What is your view on the future for structured products and alternative strategies?

The hedge fund space over the last few years became overly crowded—many people were charging high fees for nothing more than liquidity premiums or leverage. I would say a lot of hedge funds will be squeezed out of the market and what will be left behind will be roughly what approximated hedge funds 10 or 12 years ago: clever people working in public markets, exploiting inefficiencies with full transparency. So that space will become clearer and the strategies will become more transparent and funds like ours will have access to those managers for fees that will be negotiated. But hedge funds will have a lot of opportunities they have not had for a long time. And so again we will have to wait and see what is presented to us in the next few years.

Is it possible to prepare for a black swan?

Financial crises occur because of the financial system's collective failure to provision for liquidity. But if you are the one entity that does have the liquidity then you will make the market and you will capture the bulk of the returns. The only way to ride through black swans is to stay liquid, so that you're able to capitalize on stress. ■