THE COUNTDOWN HAS BEGUN

Fear, greed, and cycles of risk tolerance in global markets.

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Roughly two years have passed since global equity markets bottomed and the environment has clearly improved, particularly in the generation of cash by global corporations and in the state of their balance sheets. However, the indiscriminate nature of the rally, the strong correlation across regional markets and the outperformance of the riskiest parts of capital markets imply that much of the rally was liquidity-driven. The U.S. Federal Reserve has pursued a policy of very low interest rates, in part due to fear of a deflationary spiral similar to the one that has plagued Japan. The accommodative monetary policy of the U.S. Federal Reserve has encouraged the embrace of risk, particularly the carry trade of borrowing at low short-term rates in the U.S. to reinvest in higher-yielding securities abroad. And, this "free money" is not just available in the U.S.: real rates are negative or just slightly positive in Europe and Japan as well. Yet the Fed's repeated statements that rates will be raised at a "measured" rate have been interpreted by the markets to mean "you need to take the carry trade off, but not right away."

COUNTING ON CASH RESERVES

Many strategies currently being employed implicitly depend on a sustained period of low equity volatility and tight spreads on corporate bonds. As long as the currently high level of cash on corporate balance sheets persists, the risk of both equities and corporate bonds will be minimized and help maintain the current environment. However, there is growing pressure on corporate managers to be more aggressive with their cash balances: the rate of CEO's losing their jobs for performance reasons has risen significantly in recent years, and sitting on a hoard of cash is probably not the route to job security. Merger and acquisition activity is rebounding and many of the deals are being done for cash, not shares. In addition, equity investors are also clamoring for higher dividends and share buybacks, as the de-leveraging of corporate balance sheets has primarily benefited the bond holder. Corporate managers becoming more aggressive in using their built-up cash could lead to more leverage, greater equity volatility and larger corporate bond spreads.

However, a re-leveraging of corporate balance sheets is not the only way that the current environment could be derailed. Previous periods of Fed tightening have nearly always been precipitated by some sort of financial crisis triggered by a decline in liquidity, the Nasdaq collapse in 2000 and the Mexican "Tequila Crisis" in 1994 being two recent examples. Clearly, a crisis of that magnitude would significantly change sentiment in the capital markets and bring an end to the current period of euphoria. The current environment of low volatility and tight corporate bond spreads could persist, as there is significant technical support from Asian central banks maintaining currency levels and yield-hungry retail and institutional investors. However, as the inflating and subsequent bursting of the TMT (technology, media and telecommunications) bubble of the late 1990s showed, market trends can persist for an extended period, but the more the rubber band gets stretched, the sharper the ultimate snap-back. Now, when evaluating the larger opportunity set following the lifting of the Foreign Property Rule, Canadian investors should be aware that there is significant risk in assets which have performed well in this atypical environment, such as spread products (especially levered), structured products such as CDOs, small cap stocks, emerging markets stocks, and deep cyclicals. While there is never a good time to chase a hot tip, now is probably a worse time than ever. ■

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