



2 Big Macroeconomic Risks to Keep Canadians up at Night

Description

There is no doubt that investor sentiment on the TSX is extremely positive—the index has rallied 22% since mid-February, oil prices just cracked \$50/bbl after a two-year rout, talks of an oil-induced economic catastrophe in Canada have faded, and the S&P 500 south of the border is inching towards all-time highs.

It is important, however, that investors look beyond the current mood of the market and invest accordingly for the long term, which includes keeping an eye on looming global threats. Billionaire investor and “Canadian Warren Buffett” Prem Watsa of **Fairfax Financial Holdings Ltd.** recently released his annual letter to shareholders that outlines several of these threats, and his attitude is generally bearish.

Watsa discussed several major risks, including a potential real estate downturn in Canada, deflation in various countries, and risks from China. As a result, through derivative contracts, Watsa is betting big on deflation occurring as well as on equity markets declining.

While Watsa just glossed over some of the big threats, here are some of the key ones in more detail.

1. A China credit crisis

Billionaire investor George Soros recently stated that current credit situation in China “eerily resembles what happened in the U.S. in 2007 and 2008” and the Chinese economy is in for a hard landing. He may not be wrong, and a hard landing for the Chinese economy would affect equities in North America.

Firstly, China’s debt to GDP is a high 260%, and most of this is corporate debt. Debt levels in China are currently over twice the size of the GDP according to **Goldman Sachs** and growing at twice the pace, and, at this rate, is on track to hit 300% of GDP by 2020, a level which would potentially halt economic growth.

The main issue for China is the fact that a large amount of this credit is non-performing. Analyst Charlene Chu recently stated that in the best-case scenario, 22% of China’s outstanding bank credit is non-performing, compared to the government’s official numbers of 1.75%. During the financial crisis in

the U.S., non-performing loans peaked at 5.64%.

China's banking sector has \$30 trillion in assets, which is about 300% of GDP; compare that to the U.S., which had 100% of GDP in bank assets at the time of the crisis. High loan losses on such a large amount of debt could lead to major issues.

While China does have a \$3.5 trillion fund to help offset any loan losses, some analysts estimate a credit crisis would reduce U.S. GDP growth to as low as 0.5%, which would cost Canadian growth as both China and the U.S. are significant sources of demand for Canadian exports.

2. A Canadian real estate bubble

A second major risk is the prospect of a Canadian real estate bubble. Since the Bank of Canada cut rates in January 2015, the pace of real estate price growth in Canada has accelerated dramatically. As of March 2016 in Toronto and Vancouver specifically, real estate price growth was 15% and 22% year over year, respectively, which compared to only about 5% before the January 2016 rate cut.

The CMHC recently stated that nine out of 15 cities it monitors are overvalued. Canadians hold record levels of debt—largely in mortgages—and this debt is largely held by Canadians under the age of 45. These borrowers are typically less able to cope with financial pressures like rising interest rates or rising unemployment.

With most of the wealth of these Canadians tied up in their homes, falling home values would have a significant effect on the overall wealth of this group as well as on the earnings and balance sheets of the banks who lend to them.

How can you best protect your portfolio from these effects? One way is to buy a gold miner such as **Barrick Gold Corp.** ([TSX:ABX](#))(NYSE:ABX). Gold prices typically rise as volatility increases, and low interest rates globally combined with falling gold supply should help prices going forward. In addition, Barrick is de-risking by cutting debt levels substantially and reducing its breakeven costs, making it a much safer pick than in the past.

Barrick is aiming to generate free cash flow at only \$1,000 per ounce gold prices, and a small holding in gold is a good way to protect a portfolio for the long term.

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