IMF Warning: Household Leverage May Be an Issue for Canadian Stock Market

Description

The Canadian economy has been on an interesting ride in recent years, given the rise and fall of commodity prices, a housing boom which has failed to find a "soft landing" and continued to churn out double-digit increases annually in many major Canadian markets, and economic growth spurred largely by debt creation in the world's 10th-largest economy by GDP, according to 2016 data by the International Monetary Fund (IMF).

The Canadian economy has outpaced its G7 rivals for 2017 and is on pace to out-grow most Western nations this year largely due to a recovery in commodity prices and a continued increase in consumer debt levels, which have brought Canadians near the top of the list in terms of debt-to-income ratios globally.

The bad news

In a recent report released by the IMF, warnings of the medium-term fallout of short-term growth spurred by increasing consumer debt levels has brought to the forefront the issue of how Canada has continued to outpace most industrialized nations in debt growth in recent years. With most other nations experiencing some deleveraging from the housing crisis in the U.S. which devastated the U.S. and most global economies, the lack of a correction in Canada has led to a situation in which debt levels are currently approaching record-high levels and are approaching dangerous levels, as indicated by many independent third-party economic organizations.

The warning of a potential fallout within three to five years, stemming from short-term increases in consumer debt, comes at a time when stock price valuations are higher than ever, except for two years in the past century (1929 and 2000). The probability that relaxed monetary policy has blown up this debt bubble to incredible proportions remains to be seen; however, many influential people in the financial sector, including Robert Schiller, have indicated that this debt-fuelled bubble is indeed one of the most "scary" in recent history.

The good news

The possibility of a soft landing remains hopeful for Canadian consumers and financial institutions alike. The recently proposed strict mortgage lending rules by OSFI stand to limit the pace of alternative lending from firms such as **Equitable Group Inc.** (TSX:EQB) and perhaps cool most major housing markets in Canada at a time in which any sort of cooling measures brought on by regulators appear to be ineffective. With regulators targeting risky lending in an attempt to keep overall Canadian lending quality high, there is hope that the market may cool in the coming months and avoid a catastrophic drop, as seen nearly a decade ago in the U.S. market.

Bottom line

Most experts indicate that we are nearing all-time highs in terms of debt ratios, stock market valuation multiples, and annual housing market increases. Keeping some money on the sidelines to take advantage of any impending correction is always a good idea — perhaps now more than ever.

Stay Foolish, my friends.

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