

The tipping point?



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Banks lent people too much money to go out and buy houses. That's the underlying source of the financial crisis now gripping the US, setting up the awful feedback loop whereby sharply lower house prices drive markdowns on assets collateralized by housing, pressuring financial sector balance sheets and constraining the credit that's needed to stop sharply lower house prices.

It's horribly clear in retrospect how excessive the lending in the US was. But it couldn't have been clear while it was happening, because the banks kept doing it, and the market kept accommodating it. There were, however, obvious danger signs in the aggregate data. Paramount was the growing household financial deficit (or, in other words, the growing inadequacy of savings to fund real asset purchases). In every year from 1952 and 1999, US households were net savers, but by 2005 household net borrowing had swelled to 7% of disposable income. The credit crunch is now enforcing a return to net saving (see Chart 4 on page 2).

The household borrowing back-story to the UK financial crisis is similar. The emergence of household net borrowing in the late 1980s precipitated the crash of the early 1990s; the latest return to deficit has been larger, with correspondingly direr implications for the housing and financial markets (again, see Chart 4).

What worries us is that Canadian households have been running a larger financial deficit than households in either the US or the UK, as Chart 4 also shows. After forty years of net saving, Canadian households moved into sustained deficit in 2002. In 2007, household net borrowing amounted to 6.3% of disposable income, a wider deficit than in the UK, and not far off the peak US shortfall seen in 2005.

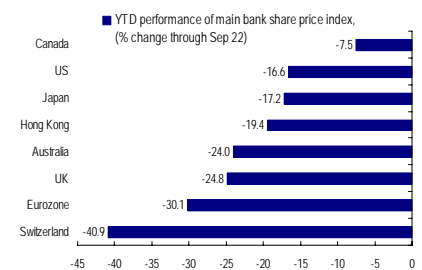
These data imply that the Canadian household sector is now overextending itself as much as the US or UK ever did, challenging the consensus view that Canadian lenders and borrowers have been far more conservative through the cycle.

So why haven't we seen housing and credit markets in Canada crack? The market view is that it's not going to, that the household overextension evident in the aggregate data is somehow more sustainable in Canada, to judge from the massive outperformance of Canadian bank shares through the global crisis (see Chart 1). We fear, however, that it may simply be a matter of time. The clear 'tipping point' in the US was the emergence of falling house prices in the summer of 2006, kicking off the vicious circles that have brought the financial system and the wider economy to the brink. We're just now starting to see house prices fall in Canada, and sharp rises in unsold home inventories increasingly imply that this will not be a transitory phenomenon (see Charts 2 and 3).

From this perspective, the absence of a Canadian credit crunch to date may be cause for concern, not comfort. How can it be good that mortgage debt is growing at a double digit pace against an asset class now seeing deflation (see Chart 5)?

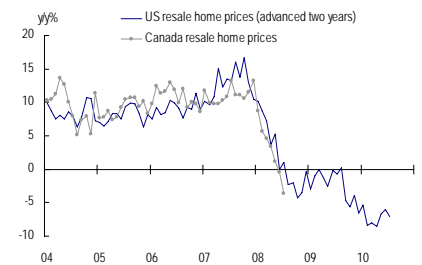
We believe that markets remain overly sanguine with respect to the prospects for the Canadian housing market, the financial sector and the overall economy.

Chart 1: Markets say no problem in Canada...



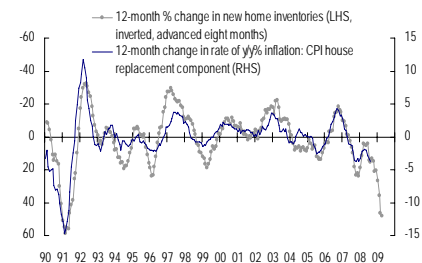
Source: Bloomberg, Merrill Lynch

Chart 2: ... but is the tipping point upon us?



Source: Haver Analytics, Merrill Lynch

Chart 3: House prices look likely to fall further

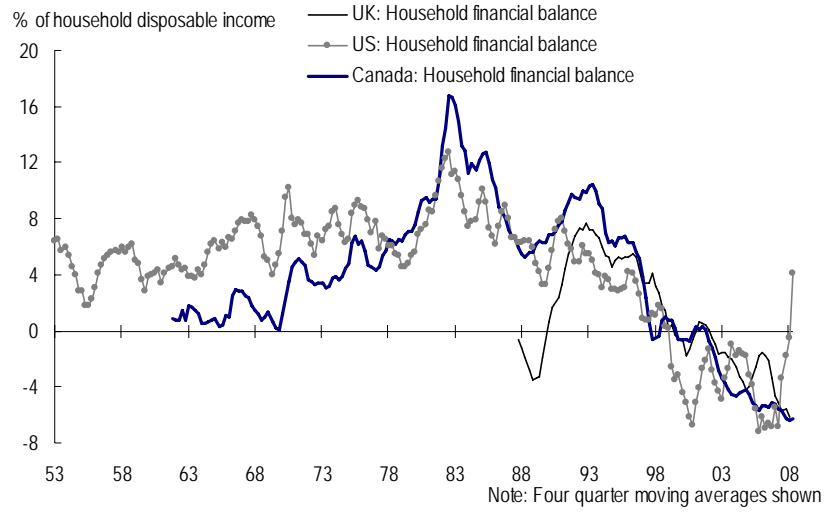


Source: Haver Analytics, Merrill Lynch

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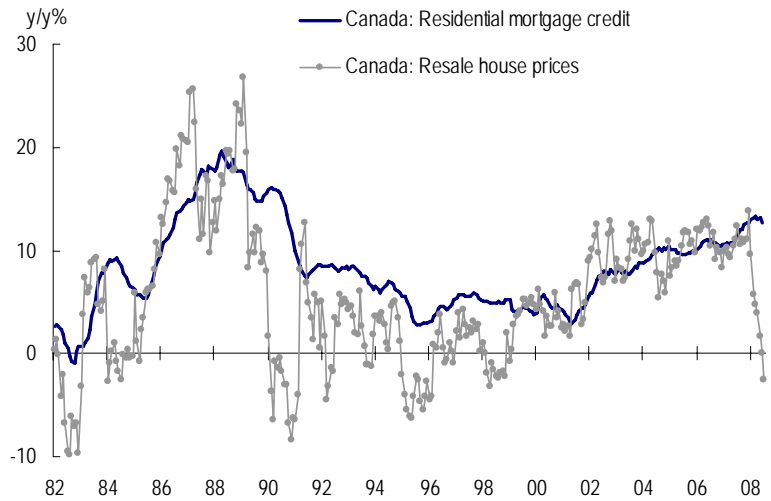
Refer to important disclosures on page 3.

Chart 4: Canadian household financial deficit as bad as in US or UK



Source: Haver Analytics, Statistics Canada, US Federal Reserve, UK ONS, Merrill Lynch

Chart 5: Lack of credit crunch may be cause for concern, not comfort



Source: Haver Analytics, Merrill Lynch

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