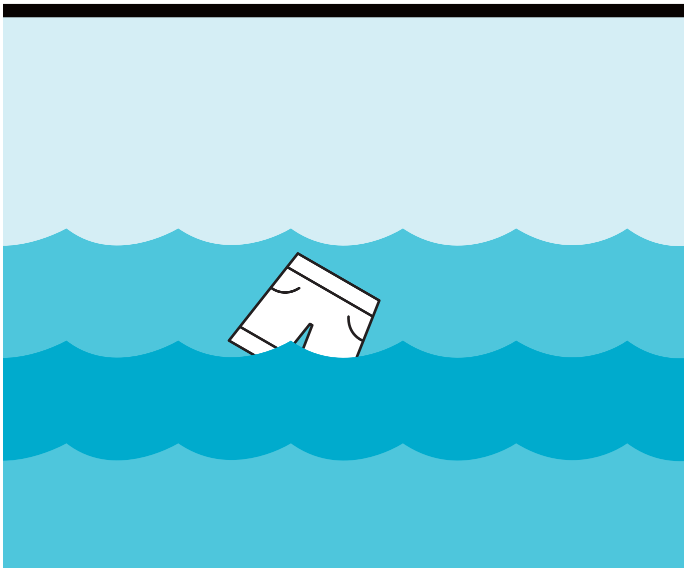

# A wave of uncertainty

Decent yields are getting harder to find as liquidity dries up

›BY ARTHUR SALZER

**ONE OF KEY TOPICS** in the wealth management industry revolves around liquidity, the ease at which an asset can be converted to cash at very close to its fair market value. Many investors seem to take liquidity for granted, but, like high tides, it seems to vanish when it's needed the most.

Since the global financial crisis, the world's central banks have been injecting liquidity into the world's largest economies: the United States, Europe, Japan and China. They have done this through quantitative easing, or QE, by buying approximately US$15-trillion worth of assets in the markets. This artificial demand created rising prices for government bonds, which, in turn, caused yields to decline. Investors who need yield began to look for it elsewhere, in places such as investment-grade corporate bonds, non-investment-grade or junk bonds, equities and real estate.

At the same time, corporations have issued more and more bonds since recent interest rates have been less expensive than what they were paying on previous issues. The proceeds from these bonds may be used to buy back more expensive debt, or various corporate transactions. Since opportunities for the productive use of capital are limited in a world that has slower economic growth, much of the money raised from the new bond issues was returned to shareholders through dividends and stock buybacks. Shareholders typically have then used this additional cash to buy riskier assets: more bonds, more stocks and more real estate.

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It's this excessive corporate leverage that was encouraged by the central banks with their zero interest rate policies and QE that has created risks to the system. In addition, private equity and hedge funds have been utilizing these lower borrowing costs to increase the leverage of their funds to finance leveraged buyouts of increasing size.

This extended period of artificially low interest rates and easy money has created very large amounts of debt that would be difficult or impossible to service under the normalized conditions of the past 50 years.

Corporate debt in the U.S. is now at US$9.4 trillion, which is 46% of the country's economic output — the same level it was at during the past financial crisis. Just as concerning is that 80% of this corporate debt is considered to be "covenant light." Half of investment-grade bonds are now rated BBB, which is the lowest quality rating. Even Janet Yellen, the former chair of the U.S. Federal Reserve, has shared her concerns about corporate debt. She sees a "huge deterioration" of lending standards and foresees a wave of bankruptcies during the next economic downturn.

With interest rates beginning to rise in North America due to central bank tightening (interest rate increases and the unwinding of QE) combined with bond market expectations of rising, albeit moderate inflation, what could this portend for investors? Declining valuations of bonds and, potentially, equities and real estate investment trusts, unless earnings increases can offset the higher costs of borrowing. In many cases, weaker or overleveraged companies could have difficulties rolling over maturing debt. The consequences could spill over to Main Street and potentially cause a slowdown in economic growth or even a recession.

Given these potential risks, accredited investors are going to have to search harder to find satisfactory return/risk propositions. In Canada, we are fortunate to have some sophisticated private debt managers that have created funds holding a diversified portfolio of loans, which are secured by underlying collateral, typically a mortgage on a real asset such as land, buildings, high-quality receivables or even something exotic like a boat or aircraft. The loan-to-value ratio will typically not exceed 70% and will be combined with additional personal guarantees by the borrower. Terms of these loans generally run from 90 days up to a couple of years. Private debt is, of course, not risk free, but a good fund will charge borrowers a sufficient interest rate as well as have the experience and legal resources to successfully foreclose on the collateral should the borrower default.

The downside is that private debt funds have moderate liquidity restrictions, since investors need to give 45 to 90 days notice of their intention to redeem their capital after a one-year initial commitment. More specialized funds that typically have higher return expectations have lock-ups of three to five years. This may sound reasonable when times are good, but be forewarned that private debt funds have the ability to gate their investors during times of financial crisis. This means redemptions are not allowed until the fund has sufficient cash available. During the last financial crisis, many private debt funds stopped redemptions for more than a year.

As Warren Buffett has said, "Only when the tide is going out, do you discover who has been swimming naked." **FPM**

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