

# The Cash Factor

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US equity bulls increasingly point to the mountains of cash held by American households and corporations as a strong buy signal, arguing that this cash will eventually find its way into the stock market, and help fuel M&A activity and capital spending. If true, this pool of available cash will be a much more important driver of stock market returns and corporate activity in Canada than in the US, given that by any relevant measure, cash holdings, by both individuals and corporations, are much larger here than they are south of the border.

### The Cash Position of Individual Investors

The amount of cash, bank deposits and money market funds held by individual US investors is now just shy of the \$9 trillion mark. This represents close to 110% of the current market capitalization of the S&P 500—the highest ratio in 15 years. That’s a bullish signal, considering that in the eight previous times that cash peaked relative to stock market capitalization, the S&P 500 rose by an average 24% within half a year. In Canada this ratio is currently smaller at 80%, but is still the highest it’s been since 1997 (Chart 1).

However, an elevated cash-capitalization ratio does not necessarily mean a higher absolute level of liquidity, since this ratio can rise due to plunging stock prices as well. Given that the US stock market underperformed the

Canadian market by 6%-points since peaking in 2007, a more informative measure of household cash holdings should be the rise in the absolute level of liquidity in both countries.

By this metric Canada actually outpaces the United States. While cash positions in the US are still growing by roughly 4% versus last year, they are up by over 12% in Canada. In fact, since the beginning of the financial crisis in mid-2007, Canadian cash balances have risen by 26%—more than twice the pace seen in the US (Chart 2).

The rapid increase in household liquidity in Canada should not be seen as a potential buffer against the growing indebtedness of Canadians. Digging a bit deeper into the numbers reveals that the increase in household liquidity has not been distributed uniformly. More than 80% of the dramatic increase in balances in personal saving and chequing accounts since 2007 was made by Canadians aged 50 and over (Chart 3). Since the excess liquidity is concentrated among a relatively narrow group with little outstanding debt, increased household liquidity will have only a marginal impact on the future trajectory of overall household debt in Canada. Simply put, the people with the debt are not the people with the money. Therefore, these elevated cash loads are more likely to find their way into equities rather than being used to pay down debt.

Chart 1  
**Individuals' Cash Holdings as a Share of Market Cap**

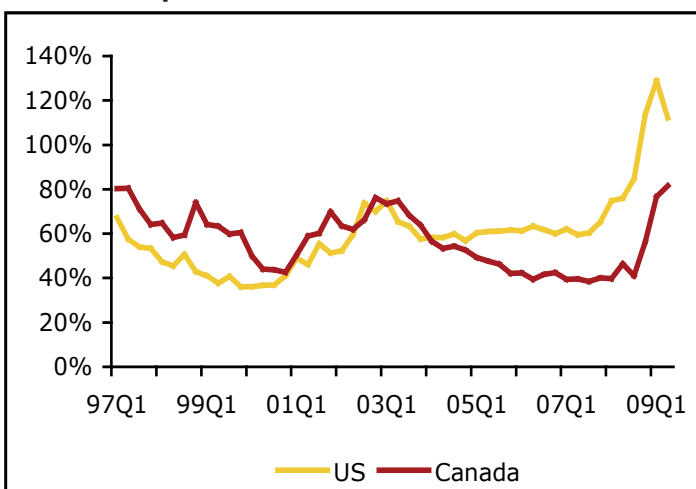


Chart 2  
**Cash at Hand in Canada is Rising Faster Than in US**

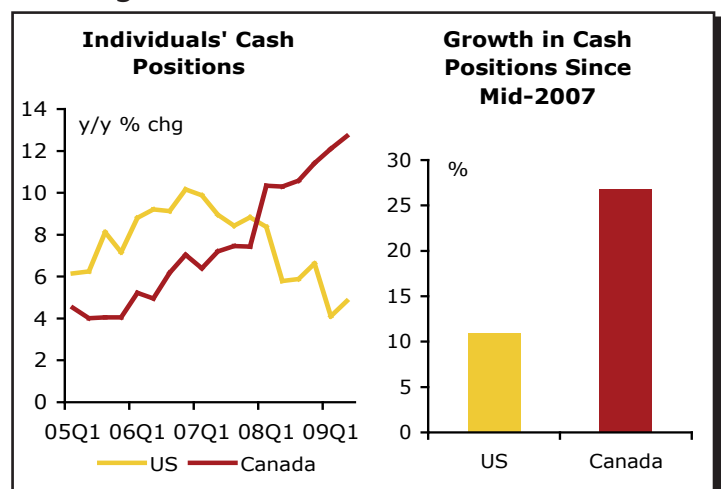
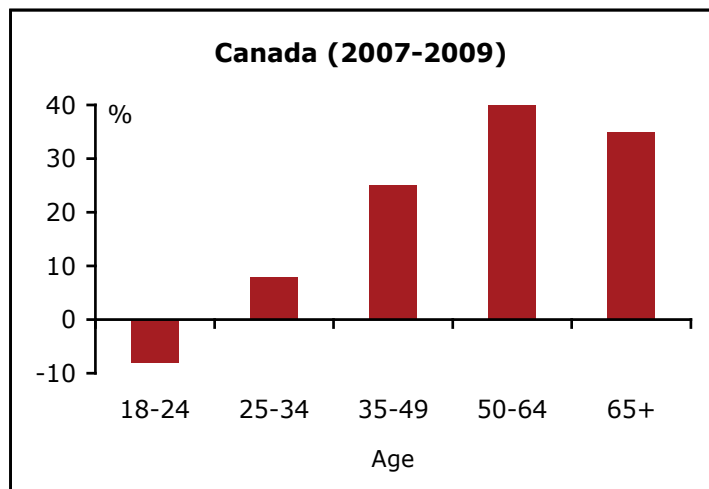


Chart 3

**Contribution to Growth in Cash Position**



To see just how much of this money could potentially head back into stocks, we need to focus on the amount of *excess liquidity* that the recent rush to cash has created. We estimate that as of May 2009 extra cash on hand (that is above the amount that would have been consistent with the long-term trend) reached close to \$250 billion in the US versus \$120 billion in Canada. Run these numbers as a share of stock market values, and you find that Canadian investors are now sitting on extra cash equivalent to about 8% of the TSX's total market capitalization—more than double the ratio seen in the US (Chart 4).

Granted, the past year's stock market crash will probably work to raise the level of risk aversion among investors,

a fact that will prevent a full reversal of the extra cash in individuals' portfolios. But the relative size of Canadians' excess cash holdings still suggests that in any redeployment scenario, the TSX will see a bigger impact than the S&P 500.

**The State of Corporate Balance Sheets**

It's not just households that are flush with cash. Despite a deep global recession and the worst financial crisis in a generation, North American firms are also highly liquid. In fact, as of the end of 2008, US nonfinancial corporations held a record \$1.6 tn in liquid assets, while in Canada the comparable tally was just over \$500 bn (Chart 5, left). As should be expected, the absolute figures favour the US, but on a proportional basis, corporate holdings of cash and marketable securities are actually larger in Canada. As of the end of 2008, liquid assets added up to 90% of short-term liabilities in Canada, but only 36% in the United States (Chart 5, right).

This measure, also commonly known as the liquidity ratio, has been on a steady upward trend in Canada since the early 1990s when it was just under 30%, one third of where it is today. During most of that period corporate liquidity also improved in the US, but that started to change in 2005 as American firms loaded up on cheap debt as the Fed kept rates low and spreads tightened considerably.

Meanwhile, Canadian firms actually spent the past few years reducing balance sheet leverage (Chart 6), helped along by a multi-year commodity bull cycle that boosted

Chart 4

**Excess Liquidity Among Individual Investors**

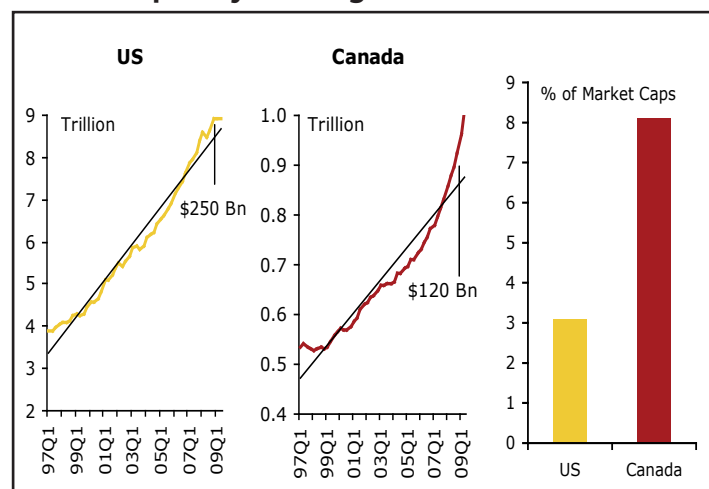
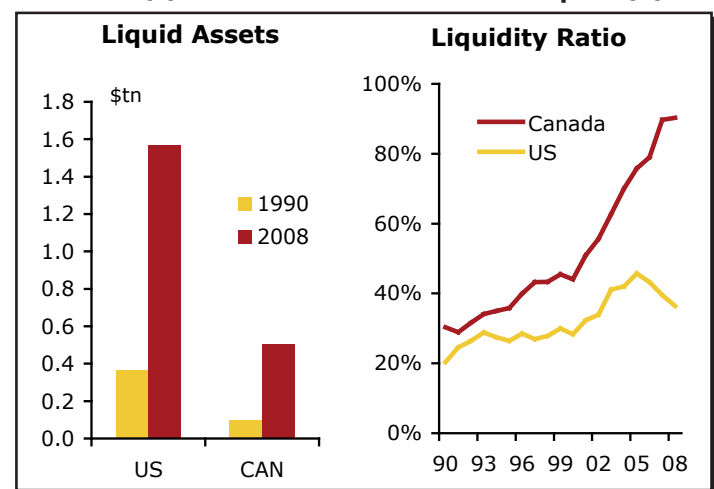


Chart 5

**Companies on Both Sides of the Border Sitting on Cash (L), Canadian Firms More Liquid (R)**



profitability and pushed the Canadian corporate sector into a net lending position, defined as the balance between internally generated funds and investment expenditure (Chart 7). After peaking in the early 1990s at over 90%, the aggregate debt-to-equity ratio for all nonfinancial Canadian firms ended 2008 at 55%. Even after a recent uptick, Canadian firms are still much less levered than their European or US peers, which have seen even larger increases in this metric (Chart 8).

To a great extent, recent developments vindicate the conservative balance sheet management of corporate Canada since the country's last deep recession in the early 1990s. However, although there is no doubt that firms, like households, will continue to place a premium on liquidity, the steady growth in financial assets in Canada has far exceeded the growth in either liabilities or other assets. This liquidity has come at the expense of lower capital spending and dividend payments, both of which should head higher. In fact, even assuming that liquidity ratios remain above their long-run average, we estimate that Canadian nonfinancial firms currently hold around \$200 bn in excess cash and cash equivalents. Compare this to the US where the comparable figure is roughly \$180 bn for an economy ten times larger.

Long upswings in investment follow periods of low corporate leverage, but there is also room for a significant uptrend in M&A activity, especially considering renewed investor appetite for risk, and the fact that corporate issuance has started to head higher again over the last three months. Canadian M&A markets saw a significant decline in deal volumes and values at the end of 2008.

Chart 6  
Canadian Corporate Deleveraging

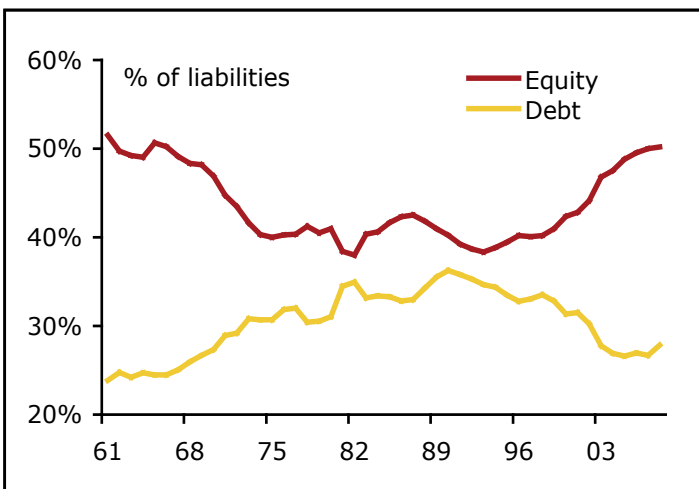
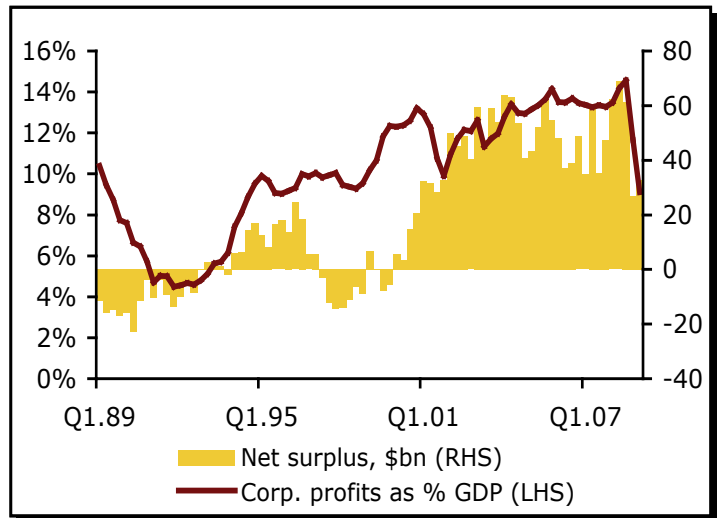


Chart 7  
Canadian Balance Sheets' Strength Fueled By Strong Profit Growth



Deal volumes fell 31% from the previous quarter to a four-year low of 271 transactions, while deal values dropped 66% to \$17.8 bn. That should start to change as global growth gets back on track next year.

The reality is that despite the recent credit crisis, Canadian firms will emerge from this period of extreme economic and financial uncertainty in a less fragile state than one might have expected, both relative to past history and to their international peers. Liquidity is high, leverage is low, and after near-term earnings weakness, the improvement in commodity prices should bode well for future profit growth.

Chart 8  
Cdn Firms Still Less Levered Than US Peers

