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In Focus

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Cashing In On Fear

by Benjamin Tal and Royce Mendes

With an ocean of fear dominating financial markets, Canadians have been swimming back to shore. Building on already elevated cash positions, investors are accumulating cash at a rate not seen in more than four years.

In fact, Canadians are already sitting on a record $75 billion of excess cash which they would typically have invested. What's worse is that, similar to the past, investors are likely going to hang onto their cash positions for too long and miss out on billions of dollars in returns.

Markets Taking an Overly Sour View of Canada

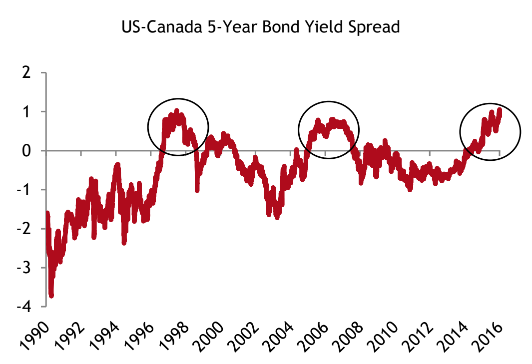
Even outside of Canada, sentiment toward the country has become very dark. Global bond traders were pricing 5-year US Treasury bonds to yield 100bps more than their Canadian counterparts earlier this month (Chart 1). That represents the widest margin on record and suggests that markets expect the current divergence in monetary policy between the US and Canada to persist for much longer than appears reasonable.

The 'short Canada' mentality hasn't been confined to the bond market. The environment surrounding Canadian stocks is also grim, with domestic equities trading more like those of emerging markets (Chart 2). Granted Canada and emerging market economies have both been adversely affected by the fall in commodity prices. But the correlation between the TSX and MSCI Emerging Markets Index shows that the negative sentiment surrounding Canada is overshooting fundamentals.

Cash is King

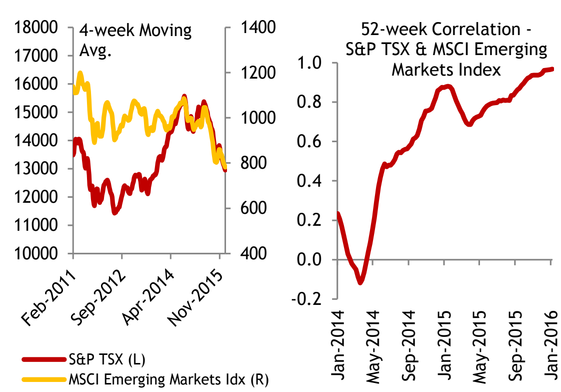
For retail investors, that negative sentiment combined with the recent volatility in stock

Chart 1
Bond Market Signaling Canada is in the Worst Shape Ever Relative to the US



Source: Bloomberg, CIBC

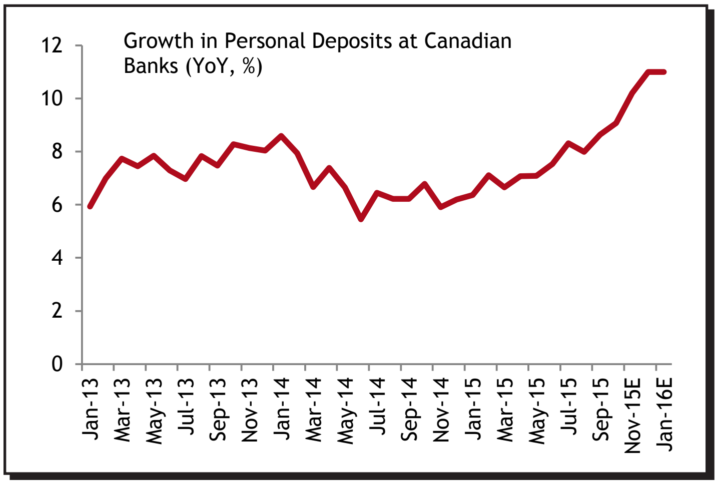
Chart 2
As Commodity Prices Slide, Canada's Stock Market Has Been Unjustly Painted With the Same Brush as Emerging Markets



Source: Bloomberg, CIBC

Chart 3

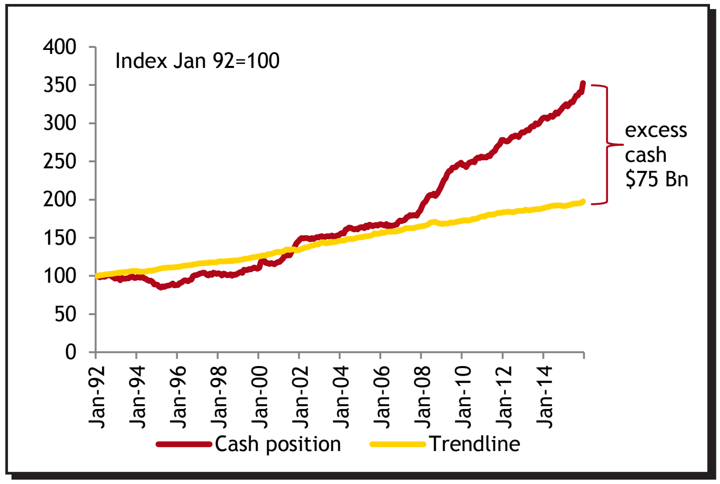
Seeking Asylum



Source: Bank of Canada, CIBC

Chart 5

$75 Billion Excess Cash



Source: Bank of Canada, Statistics Canada, CIBC

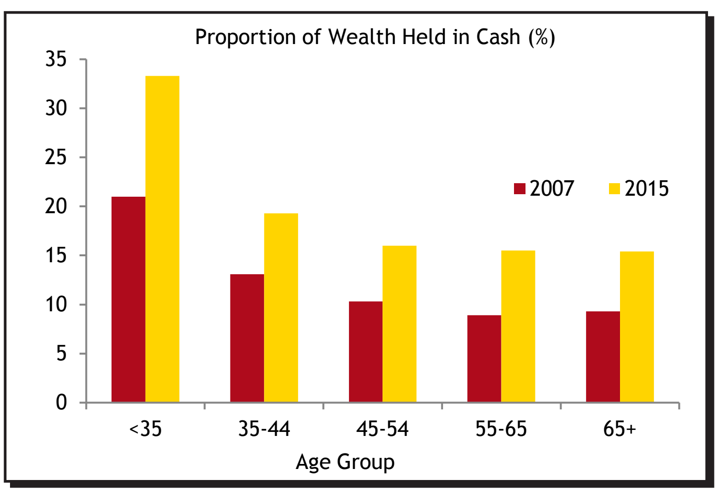
markets around the world has made for a tough investing environment. And consistent with past behavior, Canadian investors have used the current market volatility as an excuse to let cash pile up in their savings accounts. We estimate that, as of January 2016, cash positions (demand and notice deposits plus money market mutual funds) have risen more than 11% over the past year—the fastest pace since early 2012 (Chart 3).

And that trend isn't being driven by any particular age group. Both young and not so young are making cash a bigger part of their portfolios (Chart 4).

Moreover, cash positions have been rising since the 2008 recession, so the recent acceleration in the pace of accumulation is building on an already elevated level of liquidity. As a result, we're currently witnessing the creation of personal cash buffers that are larger than at any other time on record. After adjusting for the impacts of inflation and demographics (population growth and composition), we estimate that the amount of excess cash held by Canadians stood at $75 bn as of December 2015 (Chart 5). In other words, Canadians are now sitting on $75 bn of **extra** cash relative to where it should be if the level of risk aversion was not abnormally high.

Chart 4

Everyone's Doing It



Source: Canadian Financial Monitor, CIBC

That excess represents almost 10% of the total value of overall personal liquid assets in Canada. When measured in both nominal and real terms, the current value of personal liquid assets is at a record high. While holding cash can guard against short-term spikes in volatility, it's certainly a long-term drag on portfolio returns.

Elevated Risk Aversion Has Cost Canadians in the Past

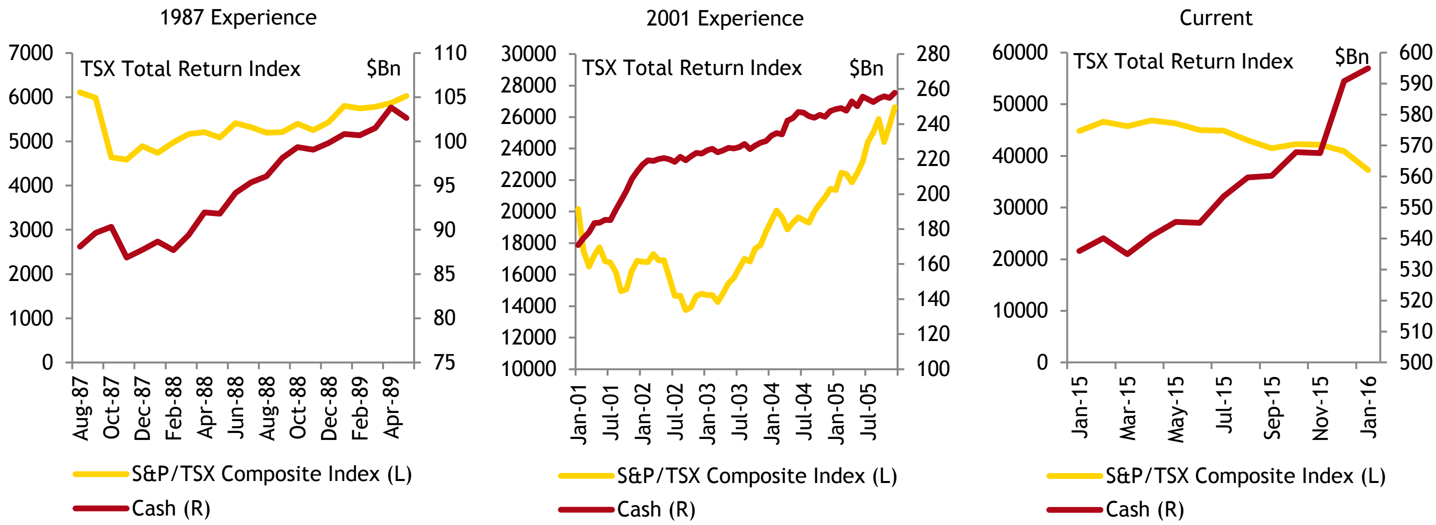
This of course is not the first time that increased market volatility has led to a flight to safety. The 1987 stock market crash led to a 20% increase in overall cash positions held by Canadian households. Following the 2001 correction, overall liquidity positions surged by more than 30%. Ditto for the great recession.

While the rush to cash during periods of volatility is understandable, Canadians maintained those elevated cash positions for far too long after markets rebounded (Chart 6).

The October 1987 stock market correction lasted two months, but investors added to their cash position for 18 months following the crash. During that time the stock

Chart 6

Sitting on Cash for Too Long



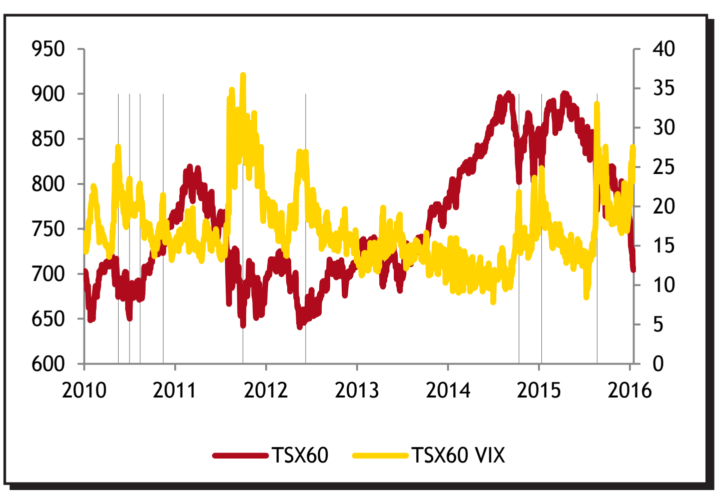
Source: TSX, Bank of Canada, CIBC

market gained more than 20%. Ditto for the 2001 flight to safety when investors reacted almost immediately to the stock market correction by aggressively raising their cash positions. But again they failed to adjust these positions when the market began recovering, maintaining record high levels during the bull market that began in early 2003. And the current rush to cash is still building on the holdings that spiked following the 2008 recession.

What's more troubling than holding cash for long periods of time is that investors often move into it at precisely the wrong time. Over the past five years, the TSX Volatility Index has peaked over the 20 mark eight times (Chart 7) and, in the 90-days following, the TSX returned an average of 9% (Chart 8). We know from the data on personal deposits that Canadians respond to such spikes in volatility by moving into cash. But that rebalancing means that investors are buying high and selling low.

Chart 7

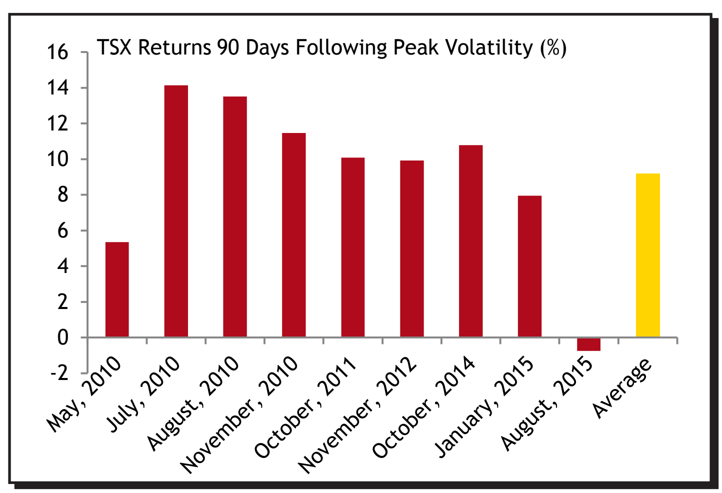
When Volatility Spikes, Investors Usually Retreat...



Source: Bloomberg, CIBC

Chart 8

.... And That's Probably the Worst Time to Divest



Source: Bloomberg, CIBC