Canso

MARKET OBSERVER

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"Half a year ago the chorus calling an end to the euro reached a crescendo. Among the chief doom-mongers were some of the world's leading economists and investors, many of them based in the United States…" Euro doomsayers adjust predictions after 2012 apocalypse averted Noah Barkin, Reuters, Friday, Dec. 28 2012

"The ill-timed advice (of Wall Street experts) shows that even the largest banks and most-successful investors failed to anticipate how government actions would influence markets." Almost All of Wall Street Got 2012 Market Calls Wrong, Bloomberg

Bearing All

The risky financial assets that were besmirched by the prognosticators at the start of the year delivered great returns for those willing to go against investment public opinion.

We started 2012 by telling our faithful readers that we thought the experts were wrong and risky financial assets had discounted much of the bad news. We were right to discount the bad news bearers last year, as the equity and credit markets surged on the tides of monetary stimulus and investor demand. The risky financial assets that were besmirched by the prognosticators at the start of the year delivered great returns for those willing to go against investment public opinion.

In the equity markets the S&P 500 was up 16.0% in the U.S. and the global indices were up double digits as well. The U.S. high yield bond market was up an equity-like 15.6% and U.S. investment grade corporate bonds returned a very strong 10.4%. The government bond market, the refuge from financial calamity recommended by the financial experts, returned a mere 2.2%. Canada lagged in the equity markets with the TSX up a mere 7.2% due to weak energy and commodity prices in 2012. The Canadian high yield market returned a strong 14.8% with Canadian investment grade corporate bonds up a very respectable 6.2%. "Safe" Canadian government bonds lagged considerably at 2.1%.

Cliffs of Worry

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The strong performance of risk assets in 2012 belied the continual search for financial doom by the market consensus throughout the year. Those who had formerly put such faith into the ability of policy makers to control market forces were so terrorized by the unknowns of the credit crisis that they could not stop their search for financial cataclysm. When it became apparent that Europe was not about to fall into economic and financial failure, the financial chattering class worried about the U.S. Presidential election. They then turned their negative gaze to Washington gridlock and the "Fiscal Cliff". Despite this obsessive "wall of worry", disaster was avoided in each case.

In a year-end interview with a financial reporter, Warren Buffet commented that the U.S. economy had reinvented itself many times and would survive the current "Fiscal Cliff" crisis reasonably intact. As long-term investors,

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we at Canso share Mr. Buffet's belief that the advice of the "Macro" experts should be accepted with a substantial dose of skepticism. The U.S. economic recovery might be delayed or diverted by Washington's gridlock but it seems to have substantial underlying momentum. The huge increase of shale gas and oil production in the U.S. is something that has come out of nowhere and leaves the energy experts struggling to understand.

Beyond the Shale

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Just when official Washington and the punditocracy is writing off the long term prospects for the U.S., it seems to us that things are changing for the better. It's interesting to us that good old American ingenuity has unleashed a shale energy productive boom that has lowered U.S. energy costs and is changing their terms of trade. The days of "financial innovation" are over and real innovation is succeeding. The bad old days of OPEC oil producers receiving U.S. dollars that needed to be recycled into U.S. investments just might be ending. The "re-shoring" of manufacturing back to the U.S. will only add to this virtuous cycle. It's hard to imagine a U.S. economy without its persistent trade deficit but it seems increasingly possible. Add in a nascent recovery in the U.S. housing market and things might actually turn out to be not that terrible in the good ol' USA.

If we're right in being positive on the U.S. economy, the problem is that reasonable economic growth might lead to higher interest rates. The bond market is now a pretty complacent place and this would be a shock to investors who are habituated to a downside mentality. Interest rates in the major developed economies are near all time lows due to the serial financial market crises and the resulting monetary policy responses, yet the bond market vigilantes of yesteryear are nowhere to be seen.

Practicing Safe Yield

At the start of 2011, there were plenty of bearish views on the upward course of interest rates. With the Euro debt crisis and the "innovative" monetary policy by the U.S. Federal Reserve and other central banks, yields plunged and most bond managers were caught well offside. Their belief in their confident predictions left them well behind in the market rally and they struggled to buy bonds to catch up. The strong demand of retail investors for "safe" yield products has also bid up the price of bonds.

The headwinds are still there for global growth. The European periphery continues its cold turkey withdrawal from its debt dependence. China's "different way" debt binge continues to loom over its weakening growth. The reregulation of financial institutions in the developed world is lowering their ability to expand credit aggregates, necessitating the continued liquidity expansion by central banks.

On the other hand, the headwinds to growth and financial fragility give central banks an excuse to keep the liquidity flowing.

Mr. Market Will Tighten

On the other hand, the headwinds to growth and financial fragility give central banks an excuse to keep the liquidity flowing. It will take a much higher and prolonged level of inflation for any central bank to even consider turning off the monetary taps. This means it will be up to the market to tighten on its

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own. Once the consensus turns away from its financial crisis obsession and wonders about the value of its long-term government bonds, yields will start to rise and Mr. Market will counteract the Fed's bond buying ways.

A steep yield curve could be a very bullish thing for the economy. As we have said many times before, there is nothing that augers more for a strengthening economy than a steep yield curve. Long Treasury yields in the U.S. are currently 2.9% and T-Bill yields at 0.1%, putting the yield curve differential at 2.8%. This could be why the U.S. economy seems to confound skeptics with its underlying strength. We expect the yield curve to further steepen. Although inflation has currently moderated with the weakness in the global economy, central banks target inflation at or above 2% and we have the sneaking suspicion that they will meet or exceed their goal.

The End of the Mayan Financial Calendar?

The "emergency" liquidity provided by central banks means that bond yields are low compared to historical norms and should move higher once it is accepted that the financial end of the world did not coincide with the Mayan calendar. Like those survivalists who prepared for the Mayan End Time and now must confront their gullibility, bond investors will have to recognize the inadequacies of the yield of their own bond refuges.

Are equities expensive? Not relative to bonds with discount rates at all time lows. On the other hand, interest sensitive stocks like utilities and Real Estate Income Trusts look quite stretched to us on an absolute basis. The "stretch for yield" has extended into the equity markets and leaves them vulnerable if interest rates increase.

A Yield Stretch Spanxing?

The stretch for yield has inflated the demand for high yield bond funds as well. In 2007, T-Bill yields were higher than the present level of some junk bond yields. We're also worried about the prevalence of high yield ETFs. Money flowing into these relatively new exchange traded funds could just as easily flow out when investors shift their gaze to equities or become disappointed in mediocre returns from the low absolute yield levels.

Remember the Budget Alamo!

Investor psychology is very important to the markets. We start 2013 in a different place than we started 2012. Investors are not bullish, but they are not terrified. Investors understand that the U.S. economy is doing better than they expected but there are still many things to worry about. The "Fiscal Cliff" was the dominant financial nightmare theme at the end of 2012 which ended reasonably with the agreement to extend the Bush tax cuts for all but the richest Americans. The consensus now worries about the extremist Republican desire for a Budget Alamo over the debt ceiling. Yes, lots of bad things can happen but good things might as well.

Melting Up

We think it's fair to say that nobody is particularly bullish or overenthusiastic. The "melt-up" of the equity markets and risk happened without a lot of fanfare or cheerleading by the financial media, who still had the financial doom

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spinners on their speed dials and interview lists. Will they now turn to positive talking heads? It's a possibility since the consensus is fated to chase hot markets and returns. We don't imagine that the peak oil enthusiasts or Slovenian political experts will be the hot interview of 2013. It's a stretch to think that a "stocks for the long term" vibe will return to the consensus in the next year but there's nothing like missing out on a rally to increase the affection for stocks and upside.

We expect any improvement, either economic or market, will be met with grudging defiance. "It's not right" will say the experts, "Things are still bad". Market rallies have a way of being unpopular, as those who have missed the boat worry about getting invested and try to argue the market back to their view. After telling clients they're better safe than sorry, going fully invested creates substantial business risk for a portfolio manager.

The Canadian Housing Pied Piper

We have to admit to being more than a little worried about Canada.

We have to admit to being more than a little worried about Canada. After Canadian policy makers have been lionized globally for their financial perspicuity we think 2013 will be the year when the housing Pied Piper gets paid. As our readers know, we have believed that the Canadian housing market departed financial reality some time ago and CMHC is an accident waiting to happen. Now that the housing market bubble is starting to deflate, we think things could get very weak, especially in Ontario.

A Canadian housing bust combined with lower commodity markets make for a potentially very weak Canadian economy. The shale oil boom in North Dakota has filled up the pipelines south into the United States and domestic Canadian oil has been stranded. The Canadian delivered oil price is $30-40 lower than the West Texas benchmark crude price which is lower than the international Brent crude pricing. The good news is that once the Canadian housing Ponzi scheme is laid bare and the extent of domestic oil price weakness is realized, the Canadian dollar should come crashing from its elevated petrocurrency levels. This would be a great tonic for central Canadian manufacturing.

Stay Invested

We believe that it is still appropriate to stay invested in risk assets.

The good news is that things are not likely to be as bad as everyone thought during the serial crises and cliffs of the past couple of years. We believe that it is still appropriate to stay invested in risk assets. We will worry about the markets when central banks begin to tighten monetary policy, valuations are stretched and the financial press is lionizing stupid investment practices. Things will go up and down but our bottom up discipline is what moves our portfolios in the right direction!

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