Canso

MARKET OBSERVER

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The Canso outlook for 2010 was for a recovering but slowly growing global economy with good financial markets. The Canadian and world economies indeed grew moderately without the dreaded "double dip" recession despite the Euro credit scare. The TSX had an excellent 17.6% return and the DEX Bond Universe turned in a solid 6.7%. This made us fairly accurate in our predictions for 2010. The picture for 2011, however, is more complicated. Despite the rally in the equity markets and rising bond market yields since September, we find the economic and market picture is more difficult to understand let alone forecast.

Life is a (Bond) Highway

Since we humans dislike uncertainty, the demand for explanation is becoming increasingly strident with the increasing economic confusion. Unfortunately, there isn't an easy answer to whether the economic recovery will continue and especially whether interest rates will rise or fall. Global central bankers, financial bureaucrats and politicians know what they want, a resurgent economy and employment. They just don't know how to get there. Their attempts to "get there" will decide the issue. Taking inspiration from the Tom Cochrane standard "Life is a Highway", we are given to explain the current economic predicament using a motoring metaphor. We believe that we are in a moderate economic recovery from the credit crisis, aided by extraordinarily loose monetary policy. This is the centre lane of a three lane economic highway. The question is whether we veer left into the fast lane of inflation and stronger economic growth or the slow lane of deleveraging and deflation. The answer to which lane we will be in at year end obviously depends on what the driver does. That driver is fiscal and monetary policy, but we are not sure the driver knows how to steer accurately.

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The Centre Lane

The renewed enthusiasm for risky assets is an important reason why we think that, absent another financial panic, interest rates will likely rise in the year ahead. The massive monetary stimulation was probably necessary to avoid a breakdown of the global financial system but it lowered administered interest rates to absurd levels. The printing of money raises the price of financial assets and avoids deflation but sustained negative real interest rates create financial manias and inevitably inflation. The monetary authorities of many countries have now concluded that their "emergency" monetary easings must now be reversed. Australia is already far along the path of tightening and now even China has embarked on the path of monetary prudency.

The quickening pace of Chinese inflation is now causing considerable concern in the leadership over its potential for political turmoil.

China carried out its massive monetary easing in the midst of the credit crisis by issuing orders to the state owned banks to increase lending. This was very successful in countering the precipitous drop in Chinese exports with domestic demand stimulation. Unfortunately, much of this lending went into the Chinese stock and property markets which are now at very speculative levels. The Chinese central government has frantically tried to slow things down with administrative measures such as higher bank reserves and loan quotas. It had avoided increasing interest rates for fear that it would add to upward currency pressure on the yuan and hurt Chinese exports. The quickening pace of Chinese inflation is now causing considerable concern in the leadership over its potential for political turmoil.

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The climbing price of cooking oil is very much on the mind of the Chinese leadership. Recent steep increases in the price of food staples are hurting the vast majority of Chinese who are still waiting to participate in the economic prosperity. This is a direct threat to the social order. The concern on inflation caused China to announce a "normalization" of monetary policy and the first increase in interest rates since before the credit crisis. Revealing a hitherto hidden sensitivity to global financial markets, a second increase in Chinese interest rates was announced on Christmas day when overseas financial markets were closed. The Chinese are also tightening by quietly allowing the yuan to continue to appreciate against the dollar, which should weaken export demand and stimulate domestic consumption and imports.

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China is not alone in its normalization, as the Chinese propagandists call it, of monetary policy. The real cost of capital in most countries is negative with short term interest rates below inflation. Savers are paying borrowers to use their money. As monetary policy normalizes, the likely course for global interest rates is modestly upwards for the next year if the economic recovery continues as we expect. The global normalization of monetary policy should still keep us in the economic centre lane. While we believe it will not stop the economic recovery, it definitely will increase the discount rate. This means that financial assets, especially government bonds, could see weakness as the interest rate structure moves up.

The Fast Lane

If central banks fail to tighten and monetary policy stays too loose once the economy has truly recovered we will be in the "fast lane" of much higher inflation and interest rates. Since modern economic policy makers take an oath to "do no economic harm", their policy responses tend to lag the economy and overcorrect in the wrong direction. Initial interest rate increases tend to be tardy and then fail to slow things enough. This scenario is really the current consensus view that the loose monetary policy will inevitably result in an inflationary spiral and higher interest rates. Easy money has a considerable momentum of its own. If things do get out of hand with inflation, as China and Australia now seem to be experiencing, monetary policy will have to not only be "normalized" but substantially tightened.

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The Slow Lane

While it looks to us like the global economic recovery is intact, there are some very troubling developments to watch out for. These stem from the increasing conservative political fashion towards "common sense" economics and policy. Both the U.S. and U.K. have had political backlashes against the bank bailouts. These have perversely caused the U.S. Democrats and U.K. Labour parties to lose elections to their conservative foes. The new U.K. coalition government has now launched an unprecedented program of government spending cuts which is a substantial fiscal policy drag.

Mr Obama is now hemmed in on using fiscal policy for economic stimulus. After their disastrous showing in the November elections, cutting government spending is the new vogue. As the Wall Street Journal puts it: *"The Republican majority that takes over the House this week plans an ambitious drive to slash government spending by tens of billions of dollars in the next few months, a strategy that ensures that the capital soon will be consumed by intense debate over how and where to reduce the size of government."* WSJ, Congress Targets Spending, Monday January 3, 2011

The U.S. Democrats and President Obama have already yielded to the Republican Congress on tax cuts. The Tea Party movement is now arguing for cutting govern-

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ment spending despite their opposition to any cuts in Social Security, Medicare or defence spending which would be highly unpopular with their constituents who voted them into office. It remains to be seen how the entrenched Washington interests will deal with the Tea Party but it is clear that conservatism is the new watchword for the Republican leadership.

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The U.S. State and local governments are also under tremendous budget pressure. Growing pension obligations and falling tax revenues are causing sharp cuts in program spending. The idea of amending the bankruptcy laws to allow States to default and restructure their debt and other obligations is now gaining traction. This has put the municipal bond market in a state of disarray as investors wonder what their bonds would be worth.

These all sum up to considerable fiscal drag as government spending wanes. The U.S. and the U.K. are not alone as Europe has its well publicized government debt issues. The melodrama over the Euro and peripheral state finances is playing out. The German voters are insisting that any support to the spendthrifts in Greece be linked to fiscal discipline with teeth. The U.K. and France have done a deal to keep transfer payments flat for the next few years. This has upset Poland, which is a major beneficiary. Politically, the European Union is very unwieldy with unanimity on the major structural changes that would usher in a fiscal union. Adding all these together, we believe that the fiscal picture in the developed economies has turned decidedly negative. The only fiscal bright spot is the extension of the Bush tax cuts and payroll tax holiday in the U.S. which should be a positive stimulus in the short term but only adds to future deficits.

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The Death of the “Prime and Pump” Fed?

The most troubling of all the political developments in Washington is the growing political pressure on the Federal Reserve to moderate its monetary policy. The Republicans are making very strong statements about “reining in” the Federal Reserve. They have appointed Congressman Ron Paul, who believes the Federal Reserve System should be abolished, to chair the subcommittee that oversees the Fed. Chairman Bernanke and the Fed Governors will face increasing scrutiny and complaint over their policy. The voting Governors on the Open Market Committee will also become more conservative as the normal voting rotation takes place. All of these conspire to limit the Fed’s latitude on the monetary front.

It is beyond the imagination of most professional investors to imagine a future without a “pump priming” Federal Reserve. The current financial class grew up in an age where Alan Greenspan eased at the first sign of financial trouble. Ben Bernanke went one further and literally made money fall from the heavens with his unprecedented creativity in financial rescue. There are now those in Washington who argue that the Fed’s “full employment” objective, which only dates back to 1978, should be removed. Consider the world with a Fed that stayed out of financial rescues and concentrated on the boring business of price stability. This might soon be the reality.

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Would tighter U.S. fiscal and monetary policy be enough to derail the current recovery? Most certainly! To continue our motoring analogy, two blown tires at high speed would likely cause our economic car to veer off the road and flip several times. Not likely but quite dangerous.

Spidey Sense Tingling

We believe that the most likely outcome is that we will stay in the centre lane of moderate economic recovery. We might drift into the fast or slow lane but we think

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it is not likely at this point. That being said, our "Spider Sense" is now tingling over increasingly restrictive monetary policy. With all around us worrying about inflation and stacking their gold bars, our contrary nature makes us think that the surprise might be the opposite. Tighter fiscal policy is a given. Tighter monetary policy is increasingly likely. What would it take to take us through the slow lane and into the ditch of deflation? Probably just what some in Washington now want to implement.

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