MARKET OBSERVER

April 2011

A bull market in risk asset prices is what we had in the quarter, defying the predictions of the economic and financial worrying class.

It has been our opinion for some time that the global economic recovery was well entrenched and would defy the pundits predicting a "double dip" recession.

"That Old Man Market, he keeps on rolling….. he keeps on rolling…..he keeps on rolling. That Old Man Market, he keeps on rolling along……." [1]

The first quarter of 2011 saw a devastating earthquake and a deadly tsunami in Japan which gave rise to a nuclear reactor meltdown. It also saw a revolt in Tunisia which spread to unrest in the rest of the Arab world. This resulted in the overthrow of Mubarak in Egypt, insurrection in Bahrain and a developing civil war in Libya which threatened oil supplies. Further cracks developed in the European sovereign debt accommodation and China tightened monetary and fiscal policy. Politicians in the United States continued to squabble over deficits and budgets, threatening an unfunded Federal government. The financial problems of state and local governments in the U.S. made it to prime time television. Public sector workers protested angrily over looming cutbacks. On the face of it, this was not quite the recipe for a bull market in risk assets.

"Showboat" Market

A bull market in risk asset prices is what we had in the quarter, defying the predictions of the economic and financial worrying class. The market continued to climb in the first quarter of 2011 and the S&P/TSX was up 4.6%, on the heels of returns over 10% in each of the last two quarters of 2010. The investment adage of bull markets being built on worries held true. The financial markets quickly discounted substantial negative news and glommed onto the positives. The other adage for investors not to "bet against the Fed" was also on the mark. Such is the power of easy money. As we have been saying for quite some time, monetary policy has been eased on an unprecedented scale. This deluge of easy money and the negative real interest rates resulting from it are a powerful elixir for financial asset prices. As we said in our introduction, or more properly should have sung, the sheer weight of money overpowered market worries and the market for risky financial assets "kept on rolling along".

The Time for Cutting is Past

It has been our opinion for some time that the global economic recovery was well entrenched and would defy the pundits predicting a "double dip" recession. This now seems to be the general market consensus. The good news is now broadening out beyond soaring corporate profits. Employers in the United States are now in the hiring mode as their sales expand.

An article on the Bloomberg website entitled *"U.S. Unemployment Rate Unexpectedly Drops to Two-Year Low of 8.8% in March"* sums it up:

> *"It does look like things have turned the corner,"* (says) *Scott Brown, chief economist at Raymond James & Associates Inc…"We're finally seeing small- and medium-sized companies hiring."… "Hiring additional personnel in preparation for the spring market is essential for success in 2011," Peter Grady, vice president of Chrysler's network development and fleet, said in a memo to dealers last month."* (Bob Willis, Bloomberg News, April 2, 2011)

(Continued)

[1] *(With apologies to Jerome Kern and Oscar Hammerstein II.)*

Governments around the world strained their finances to protect their financial systems in the credit crisis and now they have to get things back on budgetary track.

So now it looks like private employers in the U.S. are now realizing that the time for cost cutting is past and they are gearing up employment to increase sales. On the other hand, the public sector in the U.S. is retrenching in a major way, as budgets are slashed and this is weakening consumer demand as layoffs of civil servants rise. This is not uniquely an American phenomenon in the aftermath of the credit crisis. Governments around the world strained their finances to protect their financial systems in the credit crisis and now they have to get things back on budgetary track. The deal with the EU bailout devil has seen Ireland, Greece and other "Eurotrash" peripherals slash their public sector budgets which has led to a considerable political uproar.

Government Slashers

In Britain, where the coalition government has substantially slashed public spending, retail sales are quite weak. *"Retailers hit by double blow"* is the title of a *Financial Times* article that explains:

> "*"This is the worst I can remember seeing in about 30 years," said Richard Hyman strategic retail adviser to Deloitte. "Since the middle of January more or less, retail has fallen off the edge of a cliff…" Some retailers and analysts believe consumer spending has lurched even further down over the past couple of weeks as the effects of tax increases and public sector job cuts filter through to disposable incomes."* (Andrea Felsted, Financial Times, April 1, 2011)

As governments retrench, the question is obviously whether the resulting drop in consumption will be enough of an economic shock to cause another "double dip" recession. We don't think so. Our reasoning is that the increase in private consumption should be enough to offset the drop in public spending. What we're really talking about here is classic Keynesian fiscal theory. During the credit crunch and recession, governments stepped in to replace the drop in private demand with public demand. The infrastructure and other stimulative government programs now need to be replaced by private demand. If the trend with employment holds, employers should soon be turning to capital investment to get on with the plant upgrades and maintenance they delayed in the recession. If the private sector then has enough momentum to continue its expansion, the waning public sector should be offset.

The current debate between economists is really about how strong the economic recovery really is.

The current debate between economists is really about how strong the economic recovery really is. One camp looks to the 1930s to suggest that stimulus should not be withdrawn too early. This happened in the 1930s and the private sector was unable to grow enough to offset the withdrawal of fiscal and monetary stimulus. The other says the economy is destined to muddle for some time after a financial crisis and it is time to give resource allocation back to the private markets.

China's Red Hot Capitalism

Talking about the virtues of government resource allocation, a look at China's vaunted "Red Capitalism" might be in order. Many in the Chinese leadership seemed to think their success in avoiding the worst of the global credit crisis proved that their directed economic model is vastly superior to the western market based system. These very same leaders are now frantically playing "whack-a-mole" with their economic command and control apparatus to avoid the price inflation that inevitably follows an ill-advised lending binge.

For those who have not been reading these reports, we will summarize what has gone on in China. In 2008 when exports dropped substantially in the credit crisis and recession, the Chinese leadership ordered a very heavy handed government directive to "lend money" to state owned banks in order to stimulate

(Continued)

domestic demand. This happened in spades and a mighty run up in the stock market and real estate speculation was the result. All that money has eventually pushed up retail goods prices as well. This is what has the Party leaders very nervous. They have now instructed the Chinese banks to "stop lending money" with quotas and increased reserve requirements but the Chinese authorities are loath to actually increase rates. All this adds up to an inability to stop credit creation and rising inflation.

Pretty aware that rising prices are the stuff of rebellion from watching the situation in the Arab world, the Party leadership has now decided to "command and control" the retail economy as well.

Panic Buying and a Panicked Party

Pretty aware that rising prices are the stuff of rebellion from watching the situation in the Arab world, the Party leadership has now decided to "command and control" the retail economy as well. They are issuing edicts to "stop raising prices". Unilever, the Anglo-Dutch consumer company just halted a 5% to 15% increase in their Chinese prices. To quote the *Financial Times*:

> *"Chinese consumers, increasingly alarmed at the rising cost of living, cleared supermarket shelves this week of shampoos, soaps and detergents after state media said four consumer goods companies – including Unilever and Guangzhou Liby Enterprise Group – would raise prices by between 5 per cent and 15 per cent…"When you wake up and see photos of old people rushing into supermarkets in a panic, that is a signal to government that this is a serious problem," said Shaun Rein of China Market Research in Shanghai."* (Unilever bows to Beijing pressure, Financial Times, Patti Waldmeir, Robin Kwong and Alexandra Stevenson, April 1, 2011)

Obviously, the Chinese Communist Party thinks it has a nasty inflation problem.

Obviously, the Chinese Communist Party thinks it has a nasty inflation problem. Officially, the Chinese inflation rate is 4.9% but nobody believes it. Inflation is a global problem as well. Financed at zero interest rates, very few investments don't seem profitable. Loose monetary policy increased the price of financial assets in the aftermath of the credit crisis, which is what policy makers intended. This avoided financial Armageddon but its collateral damage has extended into the real goods market. Commodities are now moving up to a steady drumbeat of speculative capital. Investors are rushing to the ETF market aisle for gold, copper, wheat, and other commodities.

Whither Inflation??

The inflation hasn't had a major impact yet on final goods prices in the western countries where food prices play a much smaller role in these developed economies. On the other hand, energy prices are surging and this has led to increasing headline consumer prices. Stripping out food and energy prices shows a much more subdued level. Like the Chinese, it is politically attractive for western central banks and governments to choose their statistics carefully. At Canso, we are firmly convinced that our proprietary inflation index CPI-ATGU (CPI Excluding Anything That Goes Up) will never increase! We expect licensing inquiries shortly from major central banks.

Like the Chinese, it is politically attractive for western central banks and governments to choose their statistics carefully.

"Whither inflation?" is the clarion call to investor action. Gold bugs are promoting gold as the only financial asset worthy of investment. Television and internet spam are filled with gold hawking advertisements. Bond market mavens on Wall and Bay streets are closing their eyes and hoping desperately that the central bankers get it right. We at Canso are firmly and decidedly in the "who knows" inflation camp. Yes, unbridled money creation will debauch paper money and lead to a Weimar and Zimbabwe like hyperinflation. How much is unbridled and will we actually achieve it?

(Continued)

Our belief is that the monetary expansion in China and other nations which manipulate their currencies against the U.S. dollar is indeed unbridled.

Developing World Inflation

Our belief is that the monetary expansion in China and other nations which manipulate their currencies against the U.S. dollar is indeed unbridled. These countries are importing an ultra easy monetary policy meant to defeat inflation into their inflationary economies via their currency peg to the U.S. dollar. Inflation will likely get out of control in these economies short of breaking their pegs to the U.S. dollar.

The Philippines is a fine example of the conundrum facing the central bankers and governments of the developing world. Bangko Sentral ng Pilipinas Governor Amando Tetangco has just raised the discount rate for the first time since August 2008. *"At this point in time, we cannot rule out a further adjustment given the inflationary pressures in the global economy as well as in the domestic economy,"* says Mr. Tetangco. (Philippines' Tetangco Isn't Ruling Out Further Rate Increase, Clarissa Batino, Bloomberg News, April 2, 2011). The Philippines kept its interest rates low after the credit crisis to keep its peso competitive against other Asian currencies. Like China, it is now seeing *"faster inflation"* and *"demands for higher wages"* as Tetangco explained at a conference.

Raising Both Wages and Interest Rates?

At the same time that Mr. Tetangco is raising interest rates to fight inflationary pressures, the government is looking to raise wages to appease voters. *"President Benigno Aquino on March 31 said he's studying a possible wage increase before July should inflation exceed 5 percent."* This is meant to protect Filipinos against higher food and energy prices but it will also create further inflationary pressures. Such cross purpose economic policy is the result of the "command and control" economic vogue popularized by the Chinese which other developing nations are striving to emulate.

Market economies are designed to force adjustment on market participants.

Market economies are designed to force adjustment on market participants. If prices go up and wages do not, consumers either buy less or buy substitute goods. Yes, this forces pain on participants but it also forces down the prices of the too expensive goods. This all takes some time and those being "forced" to forego what they want or need are not happy. Economic pain makes for an angry populace as Arab Dictators have recently found out.

Credibility Lost

Of course, politicians seek to do what keeps them in power, be they Democratic, Fascist or Communist "With a Chinese Face". This causes the politicians to intervene and meddle in markets as proponents of the "whack-a-mole" economic school. The developed world can't complain. It lost its credibility on economic matters with its massive rescue of its dunderhead bankers during the financial crisis. The International Monetary Fund, the developed world's instrument of economic last resort, used to lecture developing world governments on responsible economic policy. In the past, the IMF forced "adjustment" on many developing nations in exchange for its bail out programs. After the massive bank bailouts in the developed world, this would now be tantamount to a prostitute lecturing teenagers on sexual abstinence.

What of the developed world? Well, we are still well short of unbridled monetary expansion.

Is it Time to Stockpile Gold Bars?

What of the developed world? Well, we are still well short of unbridled monetary expansion. The Fed's zero interest rate policy and quantitative easing (buying government bonds) are working to offset the deflationary effects of the bursting of the credit bubble. Although inflation has moved up recently we don't see a clear and present danger of exceeding the monetary sound barrier with a resulting inflation sonic boom.

(Continued)

Will the Fed's efforts to debauch the U.S. dollar destroy the role of paper money's role as a store of wealth? Yes, sometime in the future if they keep up their willy-nilly money creation and government bond buying. So far all their monetary largesse has ended up in financial asset inflation and bankers' bonuses. We are watching very closely to determine when "enough is enough" in monetary terms. Our determination, based on consumer prices, is that we are closer to the limit but we're not stockpiling gold bars at present.

Clearly, Canadian monetary policy is currently nowhere as loose as that of the U.S.

O Canada, True North and Inflation Free?

To us, Canada represents a "special situation" that is much different than the situation in the U.S. Clearly, Canadian monetary policy is currently nowhere as loose as that of the U.S. Not only is the Fed providing ultra loose monetary policy with near zero administered interest rates, it is also monetizing government debt with its quantitative easing through "QE2". Where the Fed might actually succeed in so soundly defeating deflation that it sparks serious U.S. inflation, we find it hard to believe that Canada would follow suit with its much more moderate monetary policy.

Canada is also a major exporter of most commodities from iron ore, natural gas, oil and wheat to hydroelectricity. A truly inflationary world would be a substantial support to the Canadian natural resource industry. The recovery in the U.S. and global economies has sharply pushed up the value of the Canadian dollar against the U.S.

.

> *"Canada's dollar rose to a three-year high versus its U.S. counterpart and approached the strongest level since 1950 as speculation the global economic recovery is quickening fueled investor appetite for higher-yielding assets."* (Canada Dollar Gains to Strongest Since 2007 on Recovery Outlook, Alexandra Harris, Apr 2, 2011 Bloomberg News)

A stronger Canadian dollar will be very disinflationary for Canadian prices. Most things produced in Canada are priced in U.S. dollars. Almost all Canadian imports are priced in U.S. dollars as well. Where inflation in China and a rising yuan is resulting in rising U.S. import prices, imported Canadian inflation is moderated by a rising Canadian dollar which lowers imports priced in U.S. dollars. The disinflationary force of a rising Canadian dollar combines with tighter monetary policy to argue against runaway Canadian inflation.

The disinflationary force of a rising Canadian dollar combines with tighter monetary policy to argue against runaway Canadian inflation.

Canadian Manufacturing in a Dollar Bind

The strength of the Canadian dollar will soon put the Bank of Canada in a bind. The Bank recognizes it must "normalize" monetary policy and would like to begin to raise short term interest rates. This would only accelerate the rise in the Canadian dollar against the U.S., Canada's most important trading partner. A high Canadian dollar is already affecting the competitiveness of Canadian manufactured goods versus American. Since many competitors in the U.S. market peg their currencies to the U.S. dollar, like China, this would weaken Canada's competitive position against these countries as well. This suggests to us that Canadian interest rate increases should be more moderate than those in the U.S.

Monetary Tightening Ends Badly

So what should a valiant investment warrior do with his or her portfolio? If central banks in the developed economies persist with their ultra easy monetary policy the answer is clear: inflation sensitive assets and gold bars! As we do not expect developed world central banks to follow the path blazed by Zimbabwe and now experimented with by China, we believe monetary policy will eventually be normalized in developed nations.

(Continued)

As always, when monetary policy is tightened, the prices of risky financial assets become less attractive versus the risk-free alternative as interest rates rise.

The normalization of monetary policy means that interest rates will rise in the United States as money becomes dearer. This will be a very grudging normalization by Bernanke and friends, as they fear repeating the mistakes of the central bank forbears by tightening too much and too early in the Great Depression of the 1930s. We think that Canada will move earlier, but highly levered Canadian consumers make for a very tentative program.

As always, when monetary policy is tightened, the prices of risky financial assets become less attractive versus the risk-free alternative as interest rates rise. Income starved investors don't have to take insane risks to earn a decent financial income. This puts risky assets under pressure relative to the happy season of monetary ease. Financial strategists, paid by banks to get people to buy their offerings, argue that "things are different this time" and that everything looks rosy for all investment eternity.

It will take some time but monetary tightening almost always ends badly for financial markets. We are usually early in sounding the alarm but our portfolios are driven towards value and away from overpriced or excessively risky investments. In the last cycle we became quite concerned in 2005. Our current advice is very much the same.

> **Canso Market Observer May 2005:** *"We are now facing a tightening of monetary policy and rising interest rates on a concerted global basis. This puts the financial markets in a very different position compared to the last five years since the Federal Reserve began its monetary easing and other central banks followed. Eventually, the tightening monetary policy will gain traction and deflate the current boom. The good news is that this should take some time. The bad news is that it will inevitably happen.*
>
> *Companies themselves are in fairly good shape with low debt and strong cash reserves. It is investors who are layering on huge amounts of debt to finance very speculative investment portfolios, especially derivative strategies. Institutional investors are also chasing returns in very risky and illiquid investments, particularly hedge and private equity funds. Historically, momentum and speculative investment strategies have been considered the territory of individual investors. This time around, the private investment pools seem to have a lock on complex investment strategies that lack any vestige of common sense."*

> **Canso Market Observer May 2006:** *"The credit market is priced for perfection. Credit spreads are woefully inadequate for the risk inherent in much of today's financial innovation. We continue to be wary of the financial markets, since so much money is being invested so stupidly. We continue to raise cash and improve the quality of our portfolios."*

We have gone from the depths of financial market panic in early 2009 to senseless speculation in just over two years.

The interesting thing to us is that this current cycle is happening so quickly. We have gone from the depths of financial market panic in early 2009 to senseless speculation in just over two years. In our experience, when capital is excessively cheap it is wasted and squandered on speculations. Capital really can't get any cheaper in the United States with the current very negative real interest rates. We turn to the bank loan market for evidence of cyclical stupidity.

The Sleaziest Financial Market

Bank loans, which had to be sold by CLOs at cents on the dollar during the credit crisis, are back with a vengeance. They are now being stuffed into retail bank loan funds and ETFs which are sold as investments that will do well in a ris-

(Continued)

ing rate environment. Bank loans are now seeing a speculative frenzy like nothing we have seen before. Market participants salivate over the LCD News reports on flows into loan funds. "Whisper Numbers", usually the turf of equity earnings reports, circulate between brokers and clients. To us, the emphasis on technical factors is evidence that the market has clearly departed from fundamentals into an orbit of self sustaining speculative excess.

Bank loans are now seeing a speculative frenzy like nothing we have seen before.

"Covenant lite" loans with reduced investor protections and loans to finance equity extraction by private equity sponsors are the new vogue. Most times these weakening features are combined to make truly awful investment refuse. In their rush to invest the cash flows into their funds, the "professionals" managing these funds are setting up to blow their brains out like the CLO and CDO collateral managers before them.

As our loyal readers know, despite the fact that Canso employs ex-bankers, we went into the last speculative blowout believing bankers were off their collective nut. The bankers running the bank loan market are now outdoing themselves. The bank loan market is perhaps the sleaziest financial market we have ever experienced.

Let's demonstrate the way it works. Bankers structure a loan with an OID (Original Issue Discount) of $1 meaning the borrower gets $99 and has to repay $100 at maturity. The bankers then charge a 2% "syndication fee" which is paid out of the money advanced. So a borrower signs up for a loan of $100 million and only gets $97 million.

Now the eager portfolio managers of bank loan mutual funds and ETFs don't get to be in the syndicate; this is only for banks. The banks then announce that the loan has traded "on the break" at $102 which is where they sell them to the portfolio managers who have to buy to "get invested" with all the cash inflows they have had. Wait a second, you say, does this mean that the banks are selling a loan they made for $97 million for $102 million? That's healthy profit of $5 million for very little effort and capital employed.

Of course, banks need profits and bankers need bonuses so there is another twist. These loans are all callable for financial advantage and can be repaid at $101. What you say? The professionally stupid investment managers are losing $1 on their investment? Yes the bankers can do the deal over again in a couple of months and collect the fees once again. The borrowers are happy because they get to loosen the covenants and security package and lower their interest rate. The bankers are paying themselves obscene bonuses once again so they're ecstatic. The bank loan portfolio managers are paying themselves 1-2% fees so they really don't care too much either. Pity the poor retail investors seeking a hedge against rising rates and getting raped by fees.

The death of this market, like the CLO market in 2008, will be that banks will get greedy and take loans into inventory to sell to the unsuspecting loan fund managers.

The death of this market, like the CLO market in 2008, will be that banks will get greedy and take loans into inventory to sell to the unsuspecting loan fund managers. When the mutual fund investors see that they are getting paid very little for the risk they are taking on or find greener investment pastures like T-Bills which actually pay interest, the stuff will hit the fan.

Loan funds will have to sell into weakness and prices will plunge because retail investors will be taking their moneys elsewhere. Banks will be caught with inventories going down in value. They will have to liquidate when their risk officers come calling.

As monetary policy tightens and interest rates rise, we expect carnage once again. It might take two or three years but it will happen.

CANSO INVESTMENT COUNSEL LTD.
is a specialty corporate bond manager based in Richmond Hill, Ontario.

Contact: Heather Mason–Wood (heathermw@cansofunds.com) or Richard Usher-Jones (rusherjones@cansofunds.com)

(905) 881-8853