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Canso Market Observer

A Quarterly Bond Market Review by Canso Investment Counsel Ltd

"With evidence of fear and liquidation rampant, we know that the future is being severely discounted and that causes us to look for evidence of reasonable future cash flows. With professional and amateur investors alike so morose, we cannot trust the "professional" outlook of Wall and Bay Streets."

Canso Third Quarter 2002 Report

Surging Optimism in 3Q 2003

What a difference a year makes! Despite the belief of financial theorists in efficient markets, the credit cycle and financial markets continue to trace their amplitude between fear and greed. Given today's surging optimism and elevated prices for risky financial assets, we decided to consult our own report from last year at this time for a reference point. Of course, it does not hurt our self-image to reflect on how stalwart and brave we were in the face of financial danger.

Investors Looked for Reasons to Sell in 2002

Things were indeed very dark last year as September drew to a close. Investors grappled with the implications of a violent bear market in stocks and corporate bonds for their portfolios. As is often the case in financial history, initial bear market declines are soon followed by rallies that end in further price setbacks. The "Dot Com" collapse was true to this script. The rallying stock market that followed the steep price drops of 2000 collapsed in the unexpected turmoil following the September 11, 2001 terrorist attacks. Those brave investors who deployed their cash reserves during this period were rewarded with a rally that lasted until the mauling of July through October 2002. With losses even compared to the lows of the fall 2001, investors were certainly in a black mood. Everything and anything became a reason to sell. As we said at the time:

"We enter the final quarter of 2002 with corporate bond spreads at historical wides, with few investors

holding out any hope for improvement. Equity markets seem down for the count and government bonds are the refuge of the nervous investor. Short and long-term yields are at lows not seen for decades. … Reversing the juxtaposition of the last two years of market turmoil compared to a reasonable economy, we now think we might have reasonable corporate bond and equity markets despite a bit of economic turmoil along the way."

We Were Understated?

Well, in retrospect, we were correct yet very understated. Even our contrarian selves could not foresee the ebullience that we now face. We have had a magnificent rally in equity prices and a collapse in corporate bond spreads. So much so, that we wonder what lessons investors have learned over the past three years. The largest price increases have come in the riskiest assets, with the very stocks that were market darlings in the boom years returning to the forefront.

Much of this is due to the return of risk capital to the less liquid market sectors, although the current enthusiasm has a large dose of "catch-up" mentality. The high yield bond market demonstrates this, where new issues are possible for companies that were shunned twelve months before.

Markets are not at Extremes

We have a mixed view of financial markets at this time. We seem neither to be at extremes of sentiment or pricing, although caution is definitely out of fashion. Neither bulls nor the bears do dominate the financial press and economists are still mucking through the dreary details rather than shilling for their marketing staff. The professional investor has voted by deploying any and all cash reserves, but it seems to us that the individuals who bought the "retire rich" pitch of their friendly mutual fund sellers are still cautious about marketable investments.

The North American and world economies continue on their lukewarm and spotty recovery, with artificially low interest rates countering the worst effects of the post 2000 financial market collapse. Order has been restored to the capital markets despite the corporate scandal hangover. The looming spectre of show trials for corporate executives and investment bankers has not crowded out the good news of resurgent markets from the business press. Even bankers have regained their "lending mojo", with the potent high of zero cost money stimulating their greed enough to offset their credit fears developed during the downturn.

Interest Rates will Stay Low Until After the 2004 Election

We expect this situation to continue until interest rates rise substantially. Given Alan Greenspan's political sensitivity to George Bush's reelection hopes, this might not happen for some time. Administered interest rates will be kept low until after the 2004 election. Long-term interest rates are another matter, however, as they reflect market forces and the prospects for inflation. Investors in U.S. treasury bonds have begun to reflect on the financial wisdom of simultaneous fiscal stimulation, through government deficits and tax cuts, and very lax monetary policy. This can be seen in the wide swings in bond prices and interest rates. If it becomes apparent that growth has moved from monetary aggregates and deficits to the economy, there is little reason for an investor to keep invested in long-term fixed rate assets at these very low interest rates.

Downside Risk in the U.S. Dollar

We think the downside risk to this fair to middling economy and financial markets lies with the fate of the U.S. dollar. The trade deficit of the United States was financed by investment flows into the U.S. during the boom years of the late 1990s. It is now being financed by the purchase of U.S. government bonds and agency securities by foreign central banks.

Countries like China, which are major exporters to the U.S., intervene to protect their currency by purchasing U.S. dollars. They end up with U.S. cash that needs to be invested. They have been investing this is U.S. treasury bonds. This is why the amount of bonds being held by the U.S. Federal Reserve for foreign central banks has climbed in the past few years.

The recent G8 pronouncement that currencies should effectively find their own levels has been taken as the markets that there will be a policy of U.S. dollar depreciation. This has been our view for some time. We agree with the market's interpretation, as it conforms to our view that the only politically acceptable solution to the U.S. trade deficit and economic problems is weakness in the U.S. dollar. We think that the waning popularity of the Bush Administration's Iraq strategy makes a decent U.S. economy and therefore lower interest rates even more imperative for Republican political reasons.

Politicians Want the Dollar Down

The political will in the United States for monetary tightening is as strong as the desire for balanced budgets, or non-existent. This means the U.S. dollar is destined to depreciate significantly. The rising political chorus in the U.S. against China's currency peg is further evidence of this strategy. What good is a soft dollar policy if one of your major trading partners won't play along?

If all of this policy plays out as desired, we will have stronger world economic growth with some commodity price inflation. The U.S. dollar weakness will also be felt in commodity prices as producers try to maintain their revenues in local currency terms by price increases. U.S. commodity producers will be happy at this as well, as it improves their revenues and profits in their own currency. Stronger growth and higher commodity prices will combine for inflation in U.S. terms, but this now seems to be the ultimate goal of U.S. monetary policy. Talk about setting the bar lower, Alan Greenspan will be able to point out the return of inflation as the triumph of his campaign against deflation! Greenspan's victory over deflation will be feted by politicians and financial journalists, and could provide a suitable juncture and legacy for his retirement.

An Unhinged U.S. Dollar Could be a Problem

The real risk to our outlook is the possibility of an undershoot of the U.S. dollar and its ramification for the world financial system. Despite the G8 belief in the efficiency of currency markets, we know that currencies are very trend and momentum biased. This means the policy of depreciating the U.S. dollar could result in downward momentum that could be hard to stop. Why would a foreigner want to be invested in financial assets that removed value in local terms? If even a small fraction of U.S. financial assets held by foreigners is liquidated in this scenario, the sheer numbers are staggering. Even a shortening of term of foreign central bank treasury holdings could spike U.S. interest rates up at the long end. Despite their patriotism, even U.S. investors should prefer financial assets that increase in their own currency terms.

An unhinged U.S. dollar could cause extreme imbalances in the world financial system. Our derivative exposed financial institutions could be sorely tested. While it is hard to predict how these shocks could careen through the caverns of world financial markets, their effects will be seen through risk premiums and currency markets. It is there that we will watch for evidence of an undesirable outcome of the U.S. dollar weakness policy.

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