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MARKET OBSERVER

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A Poke from the PIGS

The impetus for this manic swing in sentiment was the crisis of confidence in the peripheral Euro countries. Greece sparked the turmoil with the admission that it cooked its books to qualify to join the Euro currency block. The hidden debt and deficits sparked a fear of Greek default and widened to include Portugal, Italy and Spain. The exposures of European banks, particularly German and French, to the so-called PIGS created a new financial panic which turned the financial markets downwards with a force that startled the previously complacent market consensus.

Traders soon realized that the seemingly one way rally was over and emptied their inventories to match the new reality of falling prices. The financial press and market strategists quickly jumped off the bull bandwagon. A story is a story and they embraced the downwards plunge with the same enthusiasm that had propelled the relief rally upwards.

Wall Street Perfidy

Reflecting the new normal of Wall Street perfidy, it soon emerged that Goldman Sachs and other investment banks had helped the peripheral European countries hide their deficits through a series of complex financial transactions. These allowed the countries to qualify for the Euro currency union without the financial pain of reduced government spending. The problem now is their large debts run up in Euros now have to be repaid.

Domestic and international investors alike now doubt the ability and even the willingness of these countries to settle at face value with their creditors. Fire bombings and street riots tend to attract the attention of the international press and suggest that all is not well despite government protestations otherwise. The credit ratings agencies are doing what they always do, rushing belatedly to recognize the problem after the fact and kicking the financial weak when they are down. This only adds to the problem.

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Fickle is Financial Fashion

Fickle is financial fashion. The very deficit spending which promised economic salvation just a year ago is now viewed with increasing skepticism. The new wave of financial suspicion is causing governments to pledge to cut their deficits. This means tightening fiscal policy as budgets are balanced. Taxes have to be raised and spending will be cut.

The tightening fiscal policy of sovereign governments is being accompanied by budget problems at regional and local governments worldwide. The recession, especially the drop in housing market activity, has lowered the revenues from income and sales taxes. In the United States, some state and local government are mandated to run balanced budgets and cannot deficit finance. The decrease in revenues has caused these governments to lay off employees, reduce program spending and to even raise taxes.

Previously untouchable areas like police, fire and education have fallen under the budget axe.

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Too Dippy For Us

To many economists and market strategists, this fiscal stricture threatens a "double dip" recession. We are not in this camp. Central banks and governments around the world have been hosing the credit markets with monetary stimulus for almost two years and are loath to now tighten monetary policy. We believe this immense credit creation and monetary stimulus is a massive counterweight to the negative fiscal situation.

The budget tightening at all levels of government is also now a powerful force restraining inflation both from the demand and supply side.

To us, the negative fiscal situation has a silver lining. We have said in previous reports that inflation tends to fall exiting recessions as companies increase production on a fixed cost base and unit prices drop. The budget tightening at all levels of government is also now a powerful force restraining inflation both from the demand and supply side. Lower government spending frees up capacity for private production. Reductions in public sector employment also puts downward pressure on wages.

The Flagging Consensus

The existing consensus has been very solidly behind rising interest rates and inflation, given the very loose monetary and fiscal policy in response to the global credit crisis of 2008. We have commented in our recent reports that we believed the consensus had inflation rising well in advance of the actual danger. The consensus flagged the unprecedented monetary stimulation and made the leap from expanding money and credit to inflation. Where we believe the consensus is wrong is the huge drag from bank capital replenishment and debt reduction.

We find it hard to believe that inflation will run out of control in an era of debt reduction. The fuel for the financial binge was credit, not money. The ratio of outstanding credit to money is shrinking. Financial institutions, which had previously been rewarded for debt financed speculation, are now reducing both their leverage and balance sheets. Moving from 30 times leverage to 10 times leverage means that a lot of the money that central banks printed is staying invested in short term investments and government bonds at recovering banks. Borrowers, both corporate and individual, are also reducing their debt. Regulatory action is also curbing the enthusiasm of banks to lend and making it more expensive to finance riskier holdings. Although sovereign borrowing is replacing private sector borrowing, public sector spending reductions will also contribute to deflation.

A Marvin Gaye Market?

Where will this all end up? We believe we are in a Marvin Gaye market. In his famous *"What's Going On"* Marvin sang of problems and injustices. *"War is not the answer"* as he sang but *"we've got to find a way to bring some lovin' here today"* is not much in the way of a solution. There's a lot wrong economically and financially today. It's easy to throw up your hands in despair. On the other hand, cash flows are rising and cash balances at corporations are growing and the world didn't come to an end, even with the credit crunch. Commerce continues.

It doesn't seem to us that higher inflation is a great danger in an era of financial deleveraging and deflation.

We believe in the power of markets to allocate wealth. We focus on value of underlying businesses and leave the big picture to the high priests and soothsayers of Wall and Bay Streets. What of the threat of inflation, you ask? It doesn't seem to us that higher inflation is a great danger in an era of financial deleveraging and deflation. It might be around the corner somewhere as a policy response to renewed recession or financial difficulties but it is not as imminent as the gold bugs would have us believe.

Shadowing CPI

It is possible to have a recession or depression in real economic activity in a hyperinflationary economy as Weimar Germany, post Communist Russia and con-

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temporary Zimbabwe have shown us. We were given an interesting insight into this phenomenon recently by *Shadow Government Statistics* (SGI) which calculates inflation the "old way".

Modern and politically correct statisticians employ "hedonistic" quality adjustments to reported inflation.

Modern and politically correct statisticians employ "hedonistic" quality adjustments to reported inflation. When a good is improved in quality, the Bureau of Labour and Statistics Canada impute an increase in the value of the good which therefore lowers its "adjusted price" even if the actual price is increased. This is why computer deflation has substantially lowered the reported Consumer Price Index. Every time memory or chip speed is increased, the obedient statisticians lower the "adjusted price" to compensate. An inspection of the record shows that computer price deflation, courtesy of hedonistic quality adjustments, has been a huge negative force on the CPI. The statisticians don't bother to ask whether the faster spread sheet, improved memory or more pixels really benefit the user but it suits the politicians and financial bureaucrats that wish to have a lower rather than higher CPI.

John Williams at Shadow Government Statistics calculates the U.S. CPI using pre-hedonistic methods. The actual level of the CPI by this calculation runs about 3% higher than the published figure and the actual CPI was in the 9% range in early 2009, rather than the reported 5%. This caught our attention. If a 9% CPI was applied to nominal GDP growth of 1-2% for that period, the actual real growth was -5% to -6% in real terms making the recent recession very severe indeed! If very low real growth (nominal GDP-CPI) of the past ten years was based on the SGI figure, we have probably been in a stagnant no/low/negative growth period in the developed economies for some time.

It is fairly obvious that politicians and financial bureaucrats prefer to be judged on a hedonistic basis. That being said, if Williams is right, the reason things felt so weak in the last economic upswing is because we were actually really in very slow growth or recession if the non-adjusted CPI was applied.

Poorly Made in China

Our partner, Vivek Verma, brought to our attention an interesting book called "Poorly Made in China" by Paul Midler. Midler is an American who works as an agent for foreign importers in China. The book explores the endemic "quality fade" by Chinese manufacturers. After securing orders, the Chinese manufacturers substitute inferior ingredients and parts to increase their profits as a matter of course. The conclusion of the book is that the poor quality of Chinese exports has considerably lowered the quality of most consumer products in western countries. There is probably a considerable argument that consumer prices in the developed world should be hedonistically adjusted upwards to reflect the lower quality of Chinese imports. Since it suits politicians to have higher reported real growth and lower CPI linked entitlement payments, it is not very likely that western statisticians will apply hedonistic adjustments to raise reported CPI!

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You Can Bank on It!

Whether we actually have low or high inflation, what is obvious to us is that it is very difficult to earn a decent financial income at the very low level of current yields on government securities. It now takes a lot of money invested in low risk T-Bills to generate enough income to live on in most developed countries. In Canada, $1 million in 30 day T-Bills generates $2500 per year at their current yield of .25%. The Bank of Canada and the government want to ease the debt burden for indebted consumers and the government. As we have said many times on these pages, debt is not a problem when the coupon is zero!

We do not believe we are in store for a continued banking crisis. In previous editions, we have gone into the extent of government support for inane bankers. Suffice to say, we continue to believe that even bankers will have a problem going

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bankrupt when their cost of funds is near zero and central banks are stuffing accounts full of newly minted cash and buying bank bonds with abandon.

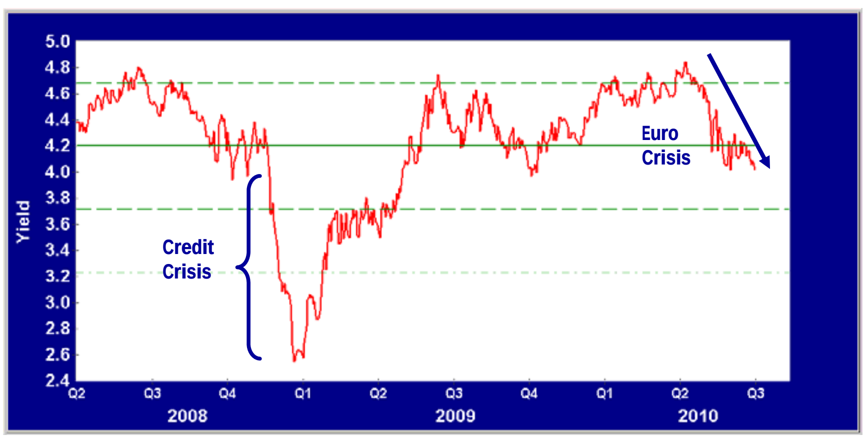
We continue to believe that the financial sector will continue its reduction in scale. In the U.S., the financial services sector weighting was 7.5% of the S&P 500 in 1990, 22% at the end of 2006 and is currently about 11.5%. With the securitization mania dead and derivatives curtailed by regulatory pressure like the "Volcker Rule", banks are back to the lower margin business of raising deposits and lending their own money. This is bad for banker bonuses but a good thing for the real economy which was collaterally damaged by the credit crunch.

Fiscally Vogue-ing

This has been a fairly controversial position to take but we point out that U.S. long term yields are surprising on the downside.

Despite the new economic vogue of fiscal responsibility, we believe central banks are a long way off from seriously tightening monetary policy. Who wants to go down in financial history as the central banker who killed the recovery? They are erring on the side of looser monetary policy and will be for some time. This means that short term interest rates will be a lot lower than they otherwise should be and that the path of longer term interest rates is not necessarily upwards. This has been a fairly controversial position to take but we point out that U.S. long term yields are surprising on the downside. The graph below shows that the benchmark long U.S. Treasury yields are now in a downwards trend, courtesy the recent Euro financial crisis.

U.S. 30 Year Treasury Yield



Source: TSX Group

Corporations are in good shape financially and are building cash balances which are already at record high levels.

Since equities return nominal GDP over longer periods, we think equities in the developed world are in for a period of moderate returns based on our expectation of moderate economic growth. The overall indices could be lower due to their heavy weights in financial services which we believe will under perform due to reductions in leverage and increased regulatory pressure. Financial institution profit margins will be lower as they are forced to exit their very profitable proprietary trading and reduce the scale of their derivatives business. The new capital standards will also increase their cost of funding for many business lines.

In terms of our outlook, we are mildly positive. Corporations are in good shape

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financially and are building cash balances which are already at record high levels.

We think that a renewed banking crisis is unlikely given the precedent of massive financial support during the recent credit crunch. Although we see lower growth for the economy, we think interest rates should stay low given the reduction in leverage in the financial system and the negative fiscal situation at all levels of government. Inflation will likely continue to surprise on the downside. Once the consensus extends this to a new "low inflation" paradigm it will be time to prepare for higher inflation and rates.

We are concentrating our fixed income portfolios on locking in the wide yield spreads on longer term corporate bonds. From our experiences on the road show for our Canso Credit Income Fund, we believe that retail investors have become a lot more income oriented. This means the retail bid for corporate bonds should continue.

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