Investment Commentary

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G8/G20: Kick the Can

I have fond memories of this childhood game. There is a version of this game being played out before our eyes by our political masters. It's called "kick the can down the road" and let someone else worry about our financial and economic problems. From our perspective, the political establishment understands the root cause of our problems; they just refuse to acknowledge it publicly. The G8 and G20 meetings in Toronto were an example of how not to openly and transparently discuss the important issues of the day. It certainly did not help that the media's attention was focused on a small group of violent protestors.

A reduction in both consumer and government borrowing is necessary, coupled with an increase in savings. ***The problem with reducing debt is that recessionary conditions are unavoidable***.

Governments mean well but it is too late in the day for effective long-term structural changes promoting growth. There is too much debt. Governments fully recognize their interference is merely a short term solution and issuing more debt will only exacerbate the imbalances and lead to another crisis. They are just kicking the can down the road.

Still, we can count on our elected officials to try periodically to fix the economy. Not willing to accept a reduction in GDP, another fiscal policy stimulus package can be expected if and when the pace of economic activity slows significantly.

Sovereign Debt Crisis

Jurgen Stark, board member of the European Central Bank, recently stated *"We may have already entered into the next phase of the crisis: a sovereign debt crisis following on the financial and economic crisis"*.

The troubles in Greece could portend bigger troubles across the developed world. Greece is potentially the tip of the "sovereign debt iceberg", as there are many nations very close to the same excessive debt levels, or will be in just a few short years. In the case of Greece and other Euro currency members, they cannot print their own money. The harsh reality is they must appease bond holders and tighten fiscal policy, or else face punishing interest rates and an eventual default. The tragedy for Greece is that protests could eventually cost them the Euro and get them back their Drachmas. They will have more money but it will be worth less.

While defending the reputation of the Euro was a decisive factor, the Trillion Euro bailout in Europe, as it was in the U.S., is all about saving the big influential banks. A bank bailout was judged necessary as French and German bankers had lent vast sums to the Greek government and its agencies.

In the depths of the 2008/9 crisis governments stepped in to provide liquidity and to guarantee private financial assets. Government debt is now being questioned. A sovereign debt crisis is brewing as public-sector liabilities grow with alarming speed. The fiscal deficits are huge and structural. Economic growth is unlikely to generate the tax revenue needed to reduce debt levels. Furthermore, due to longer-term social spending promises, in pensions and health care, it will be impossible to close the deficit gap. Advanced economies will attempt to close this gap by raising taxes and cutting spending, but it will likely be an endless battle.

It is our belief that governments, because of political expediency, are of the opinion the ultimate solution is for more "quantitative easing", or money printing. Indeed, former Fed official Chris Whalen recently commented *"We're heading towards a double-dip recession…….the only default option left is to crank up the printing presses again"*.

To default is unthinkable. To devalue is divine.

M3 Money Supply

The broadest category of money supply, M3, is showing that the amount of total credit growth in the U.S. is shrinking. Recent annualized figures show a decline of about 5%, which is shocking considering the U.S., and the developed world generally, has become dependent on debt for economic growth. While the US Federal Reserve has provided fresh liquidity into the banking system, banks and consumers are not re-circulating the money to create new loans. It appears the capacity and willingness to assume more debt is waning. Many experts share the view that the typical monetary relationships are broken. In previous cycles, a stable money multiplier meant that additional bank reserves could be counted on to create new loans.

For the first time, deleveraging is taking place as consumers seem determined to strengthen their balance sheets. The reduction in debt and decline in broad money supply is by definition recessionary. To fight it, expect authorities to engage in a desperate stop and go experiment with monetary inflation, which could easily continue for quite some time.

Inflation is the longer term threat but in the meantime a deflationary period can be expected as the forces of deleveraging, high unemployment and overcapacity, continue to undermine the economy for a while yet.

US Dollar Strength

In a bizarre and unforeseen development, the U.S. dollar has appreciated strongly so far this year. Just when everyone was ready to give up on the dollar and citing an imminent end to its reserve currency status, it has been given a new lease on life. Vis-a-vis the Euro, the dollar has appreciated some 20%, trading now at about 1.24 to 1. The troubles in Europe have certainly helped the U.S. dollar on a relative basis as flight capital out of the Euro seeks to diversify. Gold has also been a beneficiary of the European sovereign debt crisis and is becoming increasingly seen as a safe haven.

Ironically, what looked like an endless sea of dollar supply just six short months ago has now turned into a dollar shortage. To be sure, momentum traders have already jumped aboard and could give the dollar continued strength.

In time however, we would expect the situation to reverse once again. The U.S. fiscal position, and that of many state governments, is equally dismal, if not more alarming, because of the sheer magnitude involved. Attention will likely refocus on the U.S. debt predicament before too long and we would expect the dollar to weaken.

As long as commodity prices stay well behaved, primarily the price of Oil, the Canadian dollar should trade higher and close in on parity again. Only a severe global economic setback would send the exchange rate the other way and back below $.90.

Financial Reform

The US Financial Reform bill, the most important set of financial reforms in decades, finally passed; Albeit watered down in many respects, especially the Volker Rule which was to separate out investment banking activity and proprietary trading. These new laws will affect the growth in the banking sector in one very important way. It will slow the growth of credit. New rules on bank capital ratios will mean more conservative lending practices. Since credit had previously been allowed to expand at a reckless rate, contributing to growth, *and in the end the financial crisis*, limiting credit now will have a negative effect, at least until the economy has time to adjust.

In testimony before Congress, many experts have revealed that authorities knew all along the risks investment banks were taking. They simply ignored warnings, shirking their responsibilities. Importantly, in all its well intended 1,200 pages, the Financial Reform Bill has not been designed to prevent another crisis. Competence cannot be legislated.

Portfolio Strategy

Financial markets will remain highly volatile, for both stocks and bonds - **in both directions.** Both directions because expectations are still generally positive, therefore any negative economic news could send stock prices much lower. Stock prices could also rise substantially should the Central Bankers try and pre-empt a market decline by printing more money, as they have shown us over the past year.

With a slower growth scenario likely for the second half of the year, we plan on being very selective with our stock purchases. We will also attempt to be more aggressive with market timing strategies, taking advantage of the ups and downs in what is expected to be a fairly wide ranging market.

Sectors that may offer more aggressive trading include Gold, Oil and Financial Services. Should we determine that a good opportunity presents itself we may consider the purchase of exchange traded funds with double exposure. With the heightened risk, portfolio positions would likely be smaller and the holding period much shorter in time.

Cash reserves are still recommended as markets are very fluid and could become unstable, as was illustrated by the mini “flash crash” in early May that sent the Dow Jones down about 1,000 points. Caution is therefore advisable.