Investment Commentary

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Recovery or False Optimism

The rally in stocks since the beginning of March has been truly spectacular – a recovery of 30-40%. Year-to-date the major indices in North America have climbed back into positive territory with the TSX 300 well out in front, up about 15%. In the U.S. the S&P 500 is up 3% for the year. Will this rally continue and is the advance reasonable in the context of a severe credit crunch and a still very uncertain environment ahead? Yes and no. Not long ago investors were staring into the abyss and discounting the worst. Financial markets may have overreacted. Outright fear has now been replaced with some hope and optimism that the world is not coming to an end.

While we never subscribed to the depression scenario, we certainly did and still do expect a slow and difficult economic recovery. The severe shock to consumer balance sheets and the clear need to reduce debt and rebuild savings should mean a lacklustre period still straight ahead. There is bound to be disappointment if and when growth fails to impress in the months and quarters to follow.

In many regards the current optimism is based on the belief that government intervention will work. The unprecedented build-up of liquidity by central banks has for the moment given hope. Businesses and consumers are more confident that a normal recovery out of recession will ensue.

The New Normal

Business is scaling back to what many have described as the "new normal" – meaning a lower level of sales activity is expected going forward. The debt subsidized growth of the past appears over. The new reality is the consumer sector will not be spending at anywhere near the growth rates of the past decade - levels that exceeded income and wage growth. Older and hopefully a bit wiser, they are staring at retirement needs in an economic environment which is not exactly employment friendly. Yes there will be a recovery. The markets must first adjust to a lower level of growth in consumer spending.

In the private markets, corporations are doing what they need to do to survive. They are cutting costs and raising capital. Governments, on the other hand, are doing the opposite, increasing spending and plunging further into debt. Of course this is the way it's supposed to work with governments acting as a counterbalance.

The difference this time around is that the U.S. government is already bloated and is in desperate need of financing a massive and unprecedented budget deficit – *nearly $2 Trillion or 14% of GDP*.

U.S. domestic savings are not enough. As usual there is a heavy reliance on foreign lenders. Foreigners have already lent vast sums in the past and are themselves shocked at what they see - a never ending sea of red ink. The safe haven status enjoyed by the U.S. will be tested. Low interest rates and a stable U.S. dollar may become casualties in the coming year if financing the deficit becomes problematic.

No Ordinary Recession

The severe credit crunch last year is confirming evidence this is no ordinary recession. A deleveraging process is just beginning and is likely to be a longer term process. This is potentially a significant change from the post war period. It has been one long debt binge, decade after decade, inflating all assets along the way.

Too much money was borrowed for consumption as opposed to saving and investing. The manufacturing base was allowed to disintegrate. It will take time to rebuild a viable economy and steer away from a financially driven one. Ironically, government policies are trying to shore up the financial economy by encouraging more borrowing and spending. The solution to a debt problem is not more debt. Yet in a classic Keynesian response this is exactly the solution being offered.

Financial sector losses in the U.S. are now estimated at $4 to 5 Trillion. Statistically the recession is already 24 months old. In the mindset of ordinary consumers, it is about 12 months. Unemployment risks going above 12%. Moreover, this is a synchronized global recession, the first in over six decades.

Will we experience inflation or deflation? There is no easy and direct answer. A solid case can be made for either outcome depending on policy moves and cause and effect reactions. For instance, an overnight devaluation of the U.S. dollar will be immediately inflationary, while a “crowding out” scenario in the bond markets could send interest rates quickly higher. This would be deflationary - with so much leverage in the system. The inflation/deflation issue is very important and will have a direct and strong influence on investment strategy decisions in the next year or two – and perhaps sooner as financial markets may react quickly and discount policy moves well in advance.

Quantitative Easing

A contraction in lending and therefore money supply is being fought with full force. If the banking sector is unwilling to lend, the economy's rise out of recession will not be sustainable. Governments have come up with quantitative easing in an attempt to offset the decline in loan demand. The U.S. Federal Reserve is buying illiquid loans and securities from the major banks in exchange for treasury securities. It is hoped banks will then be encouraged to lend.

Additionally, governments have come to the rescue with a big dose of stimulus - a temporary free lunch. The free lunch is temporary simply because there is currently no desire to tax the citizenry. Bonds are issued instead. There are likely consequences such as higher interest rates and higher inflation down the road. There is even fear of an eventual hyperinflation; with the argument being the U.S. and possibly the U.K. will be forced to print vast sums of money to pay the bills. Countries cannot print themselves out of their troubles. It has never worked in all of economic history. Unfortunately, and inevitably, it is always the last resort of spendthrift governments.

The U.S. banking system, though saved for the time being because of government largess, ($800 billion in excess reserves thanks to the U.S. Fed), is still teetering on the edge, with many of its largest banks technically insolvent. Balance sheets are riddled with underperforming loans and questionable securities. A new round of foreclosures is around the corner as mortgages are re-financed at higher interest rates. The commercial real estate market is looking soft and credit card debt is posting higher loan losses. It is too early for the U.S. banking sector to increase borrowing and begin a new wave of credit expansion. They need to shore up their capital first.

For the U.S., printing money appears to be the only solution, and not a very encouraging one. If Brazil or Mexico were to print money, investors would shun their bond market. The consequences have always been higher interest rates and a depreciating currency. No one knows for how long it can be deferred or if the cycle of debt and credit excess can be extended.

It will take a longer period of time than the markets presently expect to create the credit expansion necessary for robust growth. Businesses are not willing to commit capital to expand operations and the consumer sector remains over-extended.

Most key economic indicators are still tentative. Unemployment is rising, capacity utilization is running at less than 70%, and retail sales are soft. The decline was steep and the world economy has deep seated imbalances. We need clearer evidence of sustainable economic activity, not simply an economy that is "less bad" than expectations.

China

The great debate at the moment is whether China can singlehandedly pull the world out of recession. There is no question that China is in the best financial shape of the G20 countries and shows great promise going forward. It appears to have resumed growing again at an 8-10% rate. However, the country needs to restructure away from export growth. While imports will rise and domestic spending will expand, China still only represents about 7% of global GDP. Growing at 8-10% is simply not enough when global GDP is estimated to decline by about 2.5% in 2009.

Nevertheless the decoupling theory is making a comeback. (Before the decline in 2008 it was believed the economies in the developing countries, namely China, could “decouple” from a slowing U.S. and Europe, providing growth at the margin, to keep the world out of recession). Confirming evidence can now be found in rising commodity prices, primarily in oil and copper. Many analysts have gone even further suggesting that if commodity prices can recover so quickly in the depths of the worst post-war worldwide recession, this must be proof the sharp slump is over.

At the moment China has its own stimulus plan and is using its massive financial stockpile - over $2 Trillion in reserves, to buy physical assets. Commodity prices are rising due to this and there is evidence of stockpiling. Again, the sustainability of this activity is the big question going forward. Importantly, the harmonious and mutually beneficial relationship between China, the investor and provider of capital, and the U.S., the debtor and borrower of capital, is strained. The imbalances between creditor and debtor are now obvious and a stark reminder that fundamental imbalances are fragile and cannot last forever.

The economies of the developing world are still reeling from the declines in Western consumption. Exports are down over 20%. However, a refocus of attention on the domestic economy is starting to bear fruit. China’s command economy appears to be getting the job done. Stimulus is being directed into infrastructure development, imports are up, and the threat of a downward spiral seems to be over.

Gold

While there is no significant inflation in consumer prices at the moment, the huge increase in bank reserves would normally guarantee an inflationary outcome. There are two main types of inflation; demand-pull and cost-push. With falling consumer and business demand it is the former that economists are concentrating on. In the short term therefore, inflation is not even on the radar screen. The latter, cost-push, will be an issue during a currency devaluation. It doesn’t make headlines until after the event.

With the endless projection of deficits and a U.S. government bent on spending more for entitlements and health care, Gold's investment appeal is as a hedge against a decline in the U.S. dollar.

A position in gold stocks should be held in client portfolios as insurance and we continue to believe the risks are high that central banks and their governments will follow policies that will debase currencies leading to inflation. If the current stimulus package in the U.S. does not work then another one can be expected. The printing of money could get out of control.

Portfolio Strategy

Stock valuations, in the aggregate, should reach a ceiling in the years ahead in recognition of higher inflation and interest rates to come. Additionally, lower growth in corporate earnings means a fair P/E multiple in the 12-14 range with dividends yields of 3-5%. Our conservative strategy will aim to purchase stocks closer to these valuation levels, if and when we can find them. Certainly, many of our holdings will need to lie outside this range for broader diversification and growth potential, and to participate in the momentum of the moment.

In this latest reporting period, companies' earnings and forward looking statements are apparently exceeding expectations. However expectations keep adjusting down. Just because things are less bad it does not mean we can expect a meaningful and sustained period of positive corporate earnings growth going forward.

Regarding fixed income markets, many respected economists see the seeds of higher rates of inflation ahead. It will not take the bond market a lot of time to figure this out and demand higher interest rates. We are maintaining short maturity positions even though yields are not very appealing. To do otherwise risks an erosion of capital as interest rates rise.

Overall we are underinvested and will only look to increasing risk levels should the markets take a breather and then only if there appears to be a strong turn again in momentum. We have our doubts the recovery will be strong and sustainable and meet investors heightened expectations in the short to medium term.