Investment Commentary

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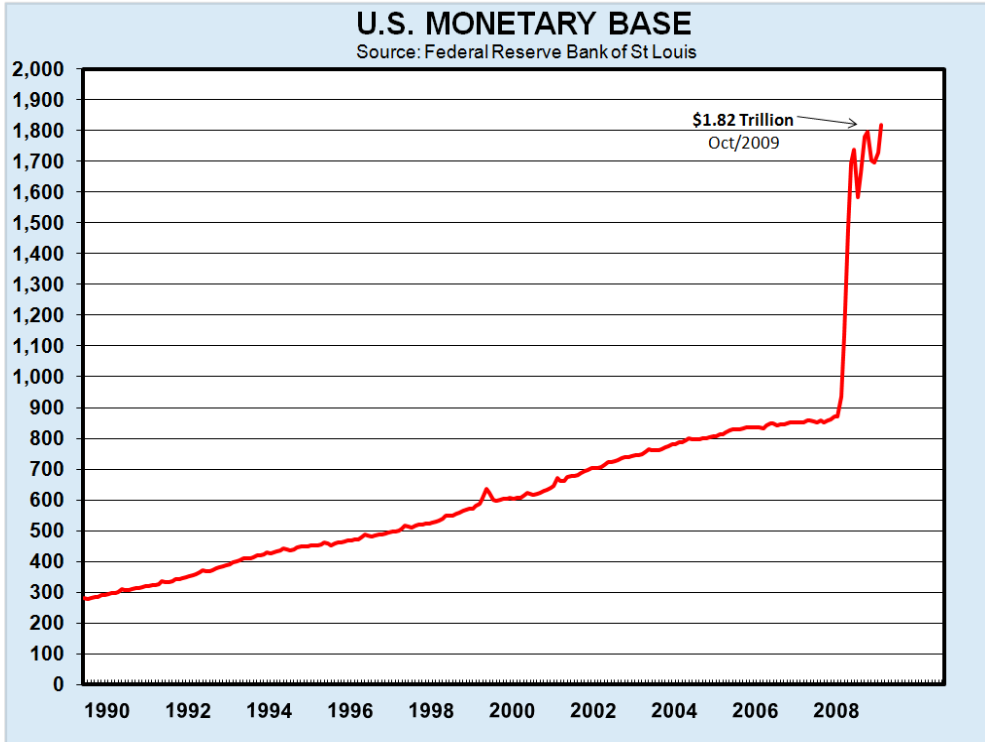
Sheer Unprecedented Genius

Or is it madness? The chart below shows the dramatic explosion in the U.S. monetary base. For decades the monetary base grew fairly consistently, doubling every ten years or so. It has just doubled again - in one year! The monetary base is under direct control of the Federal Reserve and is often referred to as “high powered money”. The increase in money is unprecedented, and it seems was justified in order to save the banking sector and prevent the world economy from seizing up last year. This was either sheer genius on the part of the Fed in averting a disaster, or absolute madness which was unnecessary and will likely be paid for with massive inflation in the years ahead. Market “experts” are divided. While no one knows exactly what the consequences will be, the uncertainty alone will mean more volatility.

Since the monetary stimulus is unprecedented and apparently another Great Depression was narrowly avoided, the logical question to ask is what led us so close to the edge? What was so different this time? It was really a confluence of factors but with one overriding theme – debt! An enormous amount of it, mainly consumer mortgage debt, causing overconsumption and serious imbalances throughout the economy. The height of irony is that current monetary and fiscal policy aims to encourage the banks to lend more money. The problem is debt, and the brilliant solution calls for more debt!

The following chart also shows what is now a rather small blip just before the year 2000 - the famous Y2K non-event. Fearing a banking run in the event computers crashed as the clocks turned the century, the Federal Reserve provided excess cash to the banking system. As it was not needed, it was promptly withdrawn. Recently there have been hints the Fed is now ready to withdraw funds seeing how the economy appears stable. We doubt an orderly withdraw could be accomplished today due in large part that the cash is needed to shore up bank capital, and to the fact the Fed has taken in unwanted securities which may prove difficult to resell.



Deflation First, Inflation Second

The deflationists point out the huge output gap in the economy and insist there are no inflationary pressures on the horizon. From a supply or production point of view, this is difficult to argue with. Capacity utilization rates around the world are still at depressed levels. Consumer demand in the developed world may stay equally depressed as high debt levels need to be reduced and savings rebuilt.

Supported mainly by the Fed's huge injection of liquidity, the higher commodity prices we are currently witnessing could prove temporary. In that regard all financial asset price gains could be seen as temporary. When the Fed begins to withdraw liquidity from the banking system, i.e., its "exit strategy", asset prices could correct significantly.

Additionally, high unemployment will serve to temper inflation in the period ahead. In the very short term it is deflation that unnerves central bankers. The broader gauge of money supply, M2, is contracting, giving evidence that bank lending is anaemic. This could keep government authorities in stimulus mode for longer than generally expected.

The caveat to any lasting deflationary scenario is the potential for run-away money supply growth. We have already witnessed what the Federal Reserve can engineer with the monetary base. Skyrocketing money reserves are now in the banking system and as soon as the economy recovers the banks will be eager to provide credit. The fractional reserve banking system will work to multiply the money supply.

Also, over the next several years U.S. budget funding needs will be massive. This will require further money printing and will place the U.S. dollar under continued pressure. A depreciating currency always leads to higher inflation.

It is becoming clear that inflationary policies are being actively pursued. Money will be borrowed and/or printed for as long as it takes. **To head off deflation, the liquidity may just keep flowing until inflation is finally visible!**

After the 2000-02 financial panic, interest rates were lowered to 3% and money was readily made available. Credit expanded and flowed into the housing sector. Every business cycle starts with loose monetary policy. It is becoming less and less effective in economic terms as more money is needed to achieve the same growth rate in GDP. This time around, without any obvious areas of the economy to expand credit to, the money could concentrate for awhile in financial assets.

In the meantime, the U.S. banking sector remains under pressure. Recent findings at some of the smaller failed banks are showing overall losses of roughly 60 to 70 cents on the dollar. Many of the larger banks in the U.S would also be forced into receivership without government funding and the suspension of certain accounting practices. They are technically insolvent. What kind of signal does that send when some companies are seen as too big-to-fail? It is a perverse system that props up failure and where bad business models remain competitive at the expense of good businesses that operate prudently.

The situation is likely much worse. That very few have been charged with fraud is itself very revealing. It confirms the strongest criticisms that securities and banking regulators are too close to the financial industry and therefore mostly ineffective.

The principles of free market enterprise are being turned on their head. Instead of allowing insolvent businesses to fail they are supported by the taxpayers. Bankruptcy, although painful and unpleasant, is healthy in the long run. The system works best and is ultimately fairer and sounder when those that fail are removed, making room and rewarding those that are more competent. The exact opposite is occurring.

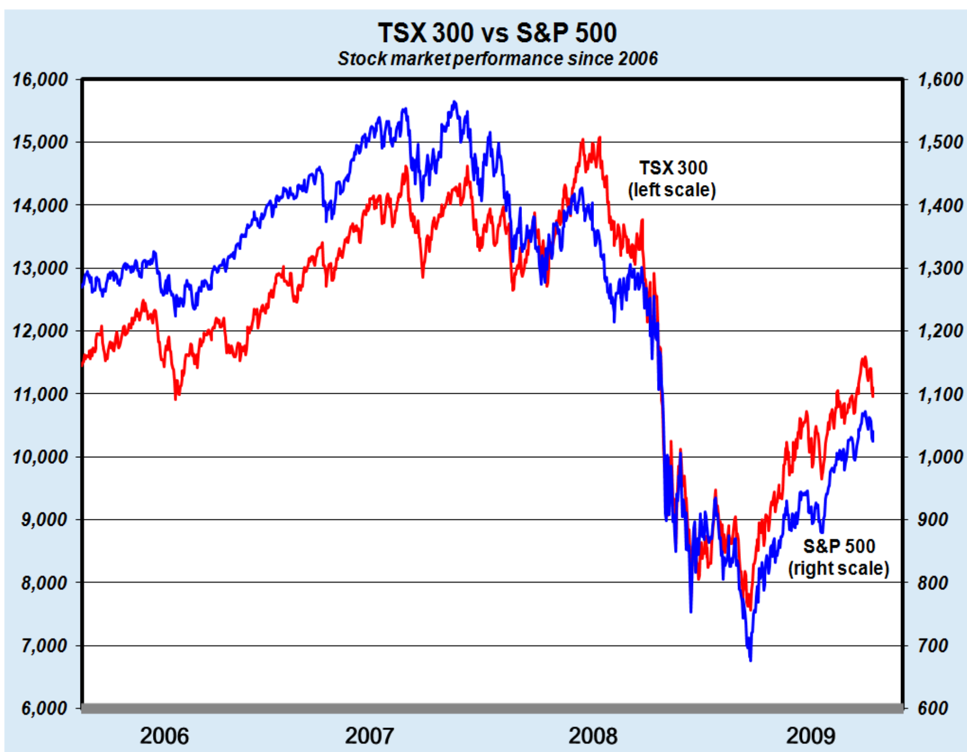
The U.S. government is doing its best to support the economy through massive fiscal deficits. Spending is up sharply annualizing at about $3.6 Trillion while tax receipts are a little over $2T. Over 40% of the budget is in red ink. In Canada the federal deficit this fiscal year is estimated at $50 Billion on an annual budget of $260 Billion, or 20% of spending. These are large deficits and will partly support eroding income levels but cannot turn the economy around.

Importantly, governments only distribute wealth. It is the private sector that creates wealth. Likewise the financial sector does not exactly create wealth. It *finances* wealth creation and takes a spread or commission. In this respect Wall Street and Washington are perfectly suited. Real wealth creation in the form of manufactured goods and productive services have been disregarded. Economic gains have unfortunately accrued in the financial sector, which has now morphed into an overleveraged depository of toxic non-performing assets. Hopefully it will now decline in importance.

Change is long overdue and is recognized at the highest levels in government circles. Larry Summers, White House economics director, has stated ***"the US must become an export-oriented rather than a consumption-based economy and must rely on real engineering rather than financial wizardry"***. Top officials acknowledge the US must rebalance its economy. The US cannot continue to be the world's consumer. Their consumers can no longer afford to borrow!

Blowing Another Bubble?

What we are witnessing now in financial markets is a pure liquidity driven bubble which is manifesting itself in several asset classes - commodities, stocks and government bonds. There are no strong and compelling *fundamental* reasons for such a sudden advance in asset prices. The hope is that fiscal stimulus will lead to a quick economic recovery and jumpstart the private sector, while the output gap continues to keep inflationary pressures contained. Interest rates can then be kept low for another year or two and investors will look forward to a strong recovery in corporate earnings. It's a perfect yarn for a dynamic stock market.



The chart above shows the sharp bounce back in stock prices. Approximately one half of the losses have been recovered. In contrast the bounce in the economy is weak and led primarily by the replenishment of lean inventories and boosted by government stimulus. There is unlikely to be much follow-through from the business sector ***to sustain an economic advance*** as the consumer is severely constrained. This is showing up in lacklustre retail sales figures and confirmed by a drop in corporate top line revenues. Among S&P 500 companies, for example, trailing twelve month revenues have declined in the order of 5-to-6%.

Investors want desperately to believe we are now out of the woods and on the way to renewed prosperity. With bailouts, money printing, too big to fail policies, expectations are such that the government will keep intervening to backstop any serious decline in the financial markets. This is not the basis of sound investing and borders on the greater fool theory.

Strategy

In the current market environment our investment strategy is to remain vigilant and to protect capital. If is our belief market valuations are now too high. It is also our belief that a stronger period of economic growth is unlikely to be realized in the short term. It is difficult to justify a full portfolio position in stocks.

Our investment objectives are to perform well over a full market cycle. Our two and three year returns are particularly good having avoided major losses in 2008. With the possibility of the other shoe dropping we remain cautious and skeptical that the economy will bounce back on a firm footing as there are many unresolved issues.

The marketplace is being distorted by extremely loose monetary policy. Investment decisions are being made based on *artificially low interest rates*. This encourages risk taking as returns in the cash market are unattractive. Investors have little choice but to chase higher yields on lower quality bonds or to pay higher prices for stocks.

We will be increasing portfolio weightings in the Utilities and Pipelines sectors, a more defensive area. Stock positions going forward will likely be trimmed in a selection of exchange traded funds. “Bear market” or inverse exchange traded funds will once again become an increasing area of our attention, especially for trading purposes should the market become more volatile.

Depending on portfolio risk levels, we continue to recommend core positions in Gold shares. The environment remains positive for Gold as excessive money printing is the order of the day.

It will be important to manage portfolio risk levels carefully and proceed with caution in the period ahead.