Investment Commentary

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"Never have such broad and severe credit-quality problems preceded a recession. Recessions cause burgeoning financial problems to intensify, not recede. Credit problems lag the business cycle, not the other way around."

Jerome Levy Forecasting Center

Not your average recession

There is little doubt the U.S. economy is in or heading towards a recession. The difference this time around is that problems in the banking sector came to light *well in advance of any slowdown in economic activity* - reinforcing the "debt bubble" theory espoused by many. Economic growth has been propped up by debt, as opposed to real gains in income and savings. This is a view still in the minority because most investors don't pay attention to larger macroeconomic forces. Those in the minority that discuss the debt bubble, and that garner media attention, usually fall into two extreme camps. At one end they are eternally optimistic and believe in a Goldilocks scenario. Those at the other extreme are the eternally pessimistic with a strict ideological bent. For these ideologues the world has been living on a knife's edge of either depression or hyperinflation for the past three decades. We will likely muddle through. We always have. However, not before some further adjustments that will keep the economy in the U.S., and also in Canada, at sub-par levels of growth.

Recessions usually witness a slowdown in the overall growth of consumer spending, though this was not the case with the recession of 2001-02, when consumers continued to spend at a fairly healthy pace. We now know the reason for this lay in the fact that consumers took advantage of a boom in housing and were able to leverage their homes. In the current slowdown home prices in the U.S. are declining rapidly. There is no longer a large refinancing or home equity withdrawal "windfall" to bolster consumer spending.

U.S. authorities are fighting tooth and nail to prevent a recession. A recession is a normal part of the business cycle. Excesses are purged as economic activity declines and then a new cycle of growth resumes. Why is it suddenly feared and resisted with such intensity?

Something is rotten in Denmark

The U.S. Federal Reserve has taken unprecedented steps to try and avoid a financial meltdown. They sharply cut interest rates by 300 basis points, stepped in to broker a deal and save Bear Sterns from bankruptcy, expanded term lending facilities ($200 Billion) and accepted mortgage-backed securities as collateral, including those from non-federally regulated investment banks! These are historic firsts for the Federal Reserve. Obviously there was a perceived need for these desperate actions. The political pressures that have certainly heightened during this election year cannot possibly explain all the commotion. The Fed obviously believes the situation is serious enough that not interfering would have been a major policy mistake. What would have happened is anyone's guess. If financial markets were really at the brink, can we now believe all the dangers have miraculously passed?

Many investment banks would be insolvent if forced to value balance sheet assets at fair market prices. The problem is potentially worse in that the assets are illiquid and therefore cannot be sold. There are simply no buyers. While the stock market seems to have settled down for the moment, a new dose of reality is likely to sink in and again fray investors' nerves. The story is far from over. The lawyers are getting ready for a field day as evidence is emerging that the banks knew the risks and openly encouraged the issuance of sub-prime mortgages and other exotic securities.

Inflation – Back to the 70's

The rise in the price of oil and base metals has now been joined by the agriculture commodities such as wheat, corn, rice, and other staples of the food industry. Many have doubled in price over a short period of time. A replay of the inflationary 1970's may be in order, with supply shocks and strong demand driving up prices.

For China, higher raw material costs, higher wage pressures and a strong currency, means this previous low cost exporter of deflation is a thing of the past. Prices of imported Chinese goods are now rising.

Inflation is always about the supply of money and credit. There has been a huge increase in credit, most of which ended up pushing up the prices of homes and financial assets. Prices for real goods and services in the economy are now rising. Comparisons to the 1970's are inescapable and inevitable. Still, we are far away from those double-digit levels of inflation. Notably, there are obstacles in the way of returning to those times; high debt and demographics.

The Great Unwinding

Low interest rates and rising asset prices encouraged the use of debt resulting in the purchase of bigger houses, more cars, home theatre systems - and the borrowing of money to buy stocks and bonds. Borrowing money has likely peaked, at least for this cycle. Debt is being reassessed, largely because of the decline in house prices. For investors in financial markets, margin debt is being squeezed as a result of the lingering problems in the banking industry. Leveraged banks must now lend less. We may see a decline in debt levels as an aging population of consumers spend less and begin to save more for their retirement. At the margin the reduction in leverage will contract economic activity. An overleveraged economy may now experience a great unwinding of debt as consumers shore up their savings. Corporate balance sheets are fortunately in fairly good shape and in aggregate do not have excessive debt - though they are exposed to their leveraged customers.

Japan's stock market and real estate bubble burst in 1990. We have cited some parallels before and continue to believe the lessons learned are critical to understanding the current situation. Japan was, and still is, a savings rich economy. It could therefore better handle a prolonged period of declining prices. In contrast U.S. savings rates are low and asset values are supported by a record amount of debt - a much more perilous situation.

To make an argument for deflation is much more complicated. The crux of the issue is debt. Every business cycle brings with it new ways to increase debt. Leverage is now commonly used in the financial services industry. For deflationary forces to be unleashed a reduction in leverage of all kinds is necessary. Betting that consumers, businesses and/or governments would reduce the use of debt has been a mugs game for countless years. Are we at a turning point? We will be closely monitoring this issue to ascertain whether a different investment strategy will need to be put in place. An unwinding of leverage will bring lower prices for almost all asset categories.

The major source of collateral for credit is now in decline. The supplier of credit, the banking sector, has been devastated. It is unlikely these institutions will be able or willing to expand their lending. A business and attitudinal shift may be transpiring.

Equity Strategy

The P/E expansion we have suggested for cyclical stocks may have begun. Agriculture commodity prices have soared recently. Fertilizer stocks have been major beneficiaries of rising crop prices, and heavily accumulated by investors. Potash Corp's valuation has risen to $65 Billion, roughly equal to that of Research in Motion, or Encana. By comparison, Imperial Oil is valued at $50 Billion and Teck Cominco is worth a mere $20 Billion. The barriers to entry for RIM are infinitely higher than for a company like Potash. While it will take a while before significant supply of fertilizer can be brought into production all you need to do is find it and dig it up. To pay $65 Billion for this cyclical company, no matter how good the medium-term prospects, is too rich for our liking. Everything must go right. There can be no surprises, either operationally, or in the confidence of the overall stock market.

Nevertheless, as current trends continue, all commodity sectors should benefit. Base metals, gold and oil stocks, notwithstanding corrections along the way, will be accumulated by investors in fits and starts as the longer term potential unfolds. Relative values are compelling. Over time we will also be accumulating positions.