# Investment Commentary

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**Contact Us**

Stonebrooke Asset Management Ltd.

WaterPark Place
20 Bay Street
Suite 1205
Toronto, Ontario
M5J 2N8
Tel: 416-850-2172
Email:
info@stonebrooke.ca

***"increasingly complex financial instruments have contributed to the development of a far more flexible system than the one that existed just a quarter-century ago"***…Alan Greenspan, from a speech to Congress given in 2005.

## Flexible **System in a State of Flux**

Former Chairman of the U.S. Federal Reserve, Alan Greenspan almost certainly regrets many things he said. The flexible system he spoke highly of is broken. The financial instruments were too complex!

With hindsight, Greenspan's monetary policies were misguided. The current financial crisis in the U.S. is rooted in the mistakes he made in encouraging the growth of "asset bubbles" – first in the stock market and now this latest bubble, currently imploding, in residential real estate.

The credibility of the Federal Reserve, now under the watchful eyes of Chairman Ben Bernanke, is slowly slipping away. The previous unquestionable faith in the Fed to correctly steer the economy is failing - *one banking failure at a time.*

The latest victims of this great financial experiment are none other than **Fannie Mae** and **Freddie Mac**, the two largest mortgage financing companies in the U.S. Between them these government sponsored entities own or guarantee almost one half of all mortgages in the U.S. – or about $6 Trillion.

The problems facing Fannie Mae and Freddie Mac should come as no surprise. These firms relied on a thin capital cushion with leverage ratios twice that of the banks! To quote William Poole, former chief of the St Louis Fed, **"these institutions are insolvent".**

There is a deep fear that a failure of either one of these mortgage lenders could create a domino-like crisis impacting a wide array of financial institutions, and thereby accelerating the current credit crunch. It is obvious now that the demise of Bear Stearns earlier this year was not an isolated event. Many investment banks took on the same kind of investment risks and are invariably teetering on the edge.

We often stated that the growth in debt expanded at an alarming rate – much more this business cycle than ever witnessed before. Financial innovations, that many now call imprudent and reckless, facilitated this expansion and led to the creation and purchase of all kinds of exotic securities, driving asset prices higher. The huge expansion of credit can no longer continue. An unwinding of the easy credit conditions that fuelled this past business cycle is now in progress.

U.S. authorities are under heavy criticism, even from members of Congress, for their blatant support of financial institutions that in the end have made bad decisions. These institutions profited handsomely in good times and now come cup in hand to the taxpayer in bad times. Egregious behaviour brought them to this point and it is only because of the financial sector's importance to the economy that they are being bailed out for the good of the people.

Since the subprime crisis erupted last year, the Fed has had to shore up countless banks with liquidity through the use of term auction facilities, essentially providing more cheap money in exchange for non marketable mortgage securities. The irony is that cheap credit was the problem in the first place.

Unfortunately, the U.S. Federal Reserve is caught in a position it cannot fully control. It can lend money in exchange for "shaky" collateral, but it cannot mandate where to invest the new liquidity. There is little choice but to throw more fuel into the fire. Hopefully a *controlled burn* is the best remedy. All other options may hold more risks and make the situation worse.

We have been here before. The recession in the early 90's resulted in significant loan losses for the banking sector. Back then it was also a mortgage financing crises with a collapse in real estate. In the end the U.S. government set up the Resolution Trust Corporation to deal with the roughly $200 billion in loan losses. Similar to today, many banks were in need of shoring up capital, and many failed. The banking system was crippled for many years.

The difference today is one of timing. When adjusted for the size of the economy the losses are already close to the same level in "real dollars" – yet officially, the U.S. has not entered into a recession. In the early 90's, as the losses were being counted the worst of the recession was over and the economy was well on the road to recovery.

The other difference is structural. Today, we have something referred to as the "shadow banking system". This is not to imply anything mischievous necessarily, however a large number of new financial players have sprung up over the years to invest in loans and securities, often using leverage supplied by the banks for which no formal statistics exist. Many of these entities are partially owned by the banks or have certain guarantees in place to take back underperforming securities. However the liabilities as such are often off-balance sheet and therefore the total banking system exposure is unknown. Fortunately the Canadian financial system is comparatively sound – though we are still missing full transparency.

## Inflation/Deflation - Revisited

Most view rising prices for oil and consumer goods as inflation. Yet a rise in stock prices or real estate is viewed differently. To some degree, each is the result of an expansion in money supply. The growth in money supply, at least the broadest measures of growth, happens to have a large “credit” component. It is this credit component, or debt, that is contributing to inflation!

Over the past two decades, central banks have become increasingly more accommodative; monetary policy has kept interest rates much lower than they should be, making it easier to borrow. While this helped the economy expand, it was a false growth. As debts appear to have finally reached levels that are unsustainable, the willingness to borrow is waning.

If the current period of financial turbulence makes debt financing more difficult to secure, a reduction in its growth means that money supply growth will slow, possibly even contract. With the banking system focused squarely on survival, they are certainly not in a position to lend anywhere near the recent growth rates.

The old debts were responsible for the inflation we experienced in the past, largely in financial assets and of course real estate. New debt is the lifeblood that keeps asset prices from falling. Unfortunately any new debt isn’t likely to prop up real estate anymore in a big way - that is yesterday’s story. The new debt is now running up commodity prices.

The bottom line is the U.S. consumer is tapped out and can no longer borrow at anywhere near the same excessive amount. Savings rates are very low. House prices keep dropping in value. This is not a recipe for inflation. To make a case for inflation would mean believing the Federal Reserve will resort to printing money. While there is concern the Fed will be forced to inflate, there is no evidence of it yet.

## *Hedge Funds/Banks Driving Commodity Prices*

Hedge funds, banks and other institutional investors have been increasing their investments in commodities for several years, with oil being the largest recipient. According to CitiGroup, global investment in commodities rose by more than 20% this year to $400 Billion. And as reported by the Commodity Futures Trading Commission, long only futures contracts are up almost 40% in number.

*The large purchases of crude oil futures contracts by these “speculators” have driven up the price of oil. Some analysts have estimated up to 40% of the price increase is due to speculation.*

Even Saudi Arabia`s oil minister, Ali al-Naimi has stated the rally in oil prices is led by investors, rather than a shortage of supply. While some traders speculate oil will reach $200 this year, many in the industry remain quite bearish. Many oil executives do not believe in the “peak oil” assertion of declining oil production. John Hofmeister, president of Shell Oil Co. in the U.S. insists the proper range is “somewhere between $35 to 65 a barrel”.

While geopolitical tensions are not to be dismissed, they cannot fully justify the current rise in the price of oil. This “insurance premium”, is estimated at anywhere between $30 to 50 per barrel. Additionally, the data shows - ***both the demand and the supply have increased over the past few years!*** With a quick jump in the price from the $40 dollar level, it would be expected that oil was in tight supply. Higher demand meeting a flat supply curve would also result in shortages. Instead the higher demand has been supplied with higher production.

Slowing demand brought about by a slowing world economy, cost pressures from prices that have tripled in under two years, and an estimated surplus production capacity of 2 to 3 million barrels per day by 2010, suggest oil prices are likely to fall. Add in a lull in Middle-East tensions and speculators may exit as quickly as they entered, bringing the oil price back down under $100. Peak oil is a sound theory but it may still be a few years away.

### *Bear Market Confirmed*

With the U.S. stock markets down 20% from peak levels, a bear market is now confirmed. There is nothing sacrosanct about a 20% correction. It simply confirms that the economy has slowed and corporate profits are weaker. The Canadian market has fared better, down only 12%. The average Post-War bear market decline is about 30% and lasts 15 months. The last time around, in 2000-02, *both* stock markets fell by 50%. The 1973-74 recession saw stocks also fall by about 50%. We bring up this earlier period because many pundits are comparing the current conditions of rising commodity prices, with the inflationary 70's. No period is exactly the same. This time around the real estate market is plunging and interest rates are still very low. International financial markets and global trade patterns have advanced and expanded. The dynamics are different. Nonetheless, bear markets usually end with capitulation, a wholesale distaste with the stock market. We are not there yet.

## Equity Strategy

As is often said in bear markets, "Cash is King". In this market climate patience and preservation of capital are of prime importance. The U.S. banking sector has been slaughtered as have many consumer discretionary stocks both sides of the border. The next several months could see distressed pricing in many other sectors. For the moment we continue to recommend a large holding in cash.

The period ahead still promises to be problematic for the banking sector. Loan growth can be expected to slow down. Trading activity in the more exotic structured products, a very important profit center, has certainly declined. Growth prospects are looking dim to say the least and survival is now the name of the game. While new government initiatives will attempt to revive the U.S. banking sector there is only so much that can be done. As investments, we are inclined to wait and pick them up closer to book values. For the Canadian banks that is still a significant discount from present levels.

Many retailers are cutting capital spending, and preparing for the worse. For the first time in the company's 30-year history, Home Depot, the second-largest retailer in the U.S. is closing 15 stores. Starbucks is closing 600 stores and laying off 12,000. The only retailers enjoying any success are the discounters such as Wal-Mart and Costco. This in itself is very telling. Needless to say we are still avoiding this sector although compelling value is starting to surface.

Emerging markets have not performed well, with the exception of those that are resource based. The developing world's stock markets have stalled in concert with the slowdown in the developed world. Inflationary pressures are rising fast. The masses are disgruntled in the face of rapidly rising food and energy prices which take up a large portion of their discretionary spending. Tighter monetary policies are likely, leading to higher interest rates and stronger currencies. At some point it will be advantageous to take a portfolio position in these markets as longer-term economic growth should be attractive for equity prices generally.

We can expect continued volatility that will impact returns this year with periodic price corrections in financial stocks, commodities, including Gold and Oil, perhaps even dramatically. The market can be counted on to move quickly in any direction as investors make the most of leverage and attempt to "hedge" positions in an effort at capturing short-term trading profits. This is a challenging environment for prudent investing. These uncertain times call for a more conservative equity strategy.