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THE INFLECTION POINT ?

If history is our best guide, we must be able to differentiate the economy from the stock market, Main Street from Wall Street and Bay Street, emotional investment decisions from rational and proactive choices. These days, every economic indicator has gone off the rails and the situation is getting worse, whether we're talking about consumer spending, real estate foreclosures, corporate bankruptcies, bank bailouts and failures, and surging unemployment to name a few. We seem to be stuck in an unstoppable downward spiral that keeps feeding on itself. Investment sentiment is way down and so are the stock markets. This phenomenon is occurring on the heels of an impressive period of growth that lasted over 25 years. With interest rates peaking at around 20% in 1980-81 as a result of a long fought war against inflation, saving became the "in" thing, consumption was limited to the bare necessities and inflation was beaten. To get the economy going again, we needed spending to pick up, but in a controlled fashion, to avoid triggering inflationary behavior. A new trend for interest rates was set and, with the exception of a few upward inflation-controlled adjustments along the way, they kept dropping. Consumer behavior did an about face, going from saving to a spending spree that resulted in the recent real estate bubble – the source of the current crisis. Perhaps if the Twin Towers hadn't fallen, interest rates could have been nudged upward earlier, avoiding a bubble of this magnitude. But my intent here is not to explain once again how we got ourselves into this mess - we covered that topic in our previous newsletter (#40). Rather, I would like to compare this crisis with past ones, to try to learn from them so that we can apply a most logical and appropriate investment strategy to counter upcoming economic challenges and take advantage of market reactions.

Few of you would know about the "Long Depression" of 1870s, which began with the "Panic of 1873", but most of us have heard or read about the "Great Depression" of the 1930s that resulted from the "Crash of 1929". In between those two events came the "1907 Bankers' Panic" which was solved by the innovative "bad bank" (the TARP of its day) orchestrated by J.P. Morgan and earned him national recognition and respect. All these crises were lead by credit expansion abuse and resulted in spending contraction. Statistics show that unemployment reached 50% in 1870s vs. 25% in the 1930s, however, the Great Depression lasted the longest. In fact, it took the Second World War to bring an end to it as everyone had to work and couldn't spend. As a means to rationing scarce commodities, coupons and ration books were used by everyone. After the war, consumers suddenly found themselves with money to spend and set about rebuilding the American Dream.

Federal Reserve Board Chairman Ben Bernanke's reputation is based on his doctoral work on monetary policy, particularly during the Great Depression. At that time, the Fed could not expand monetary policy far enough to "reliquify" the financial system, partly due to gold standard limitations, which prolonged the Depression. The gold standard was lifted in 1968 and triggered a monetary expansion which led to inflation and a commodity-driven market similar to the 2002-2008 cycle. It was the era of the

"Nifty Fifty" (50 blue chip, large cap stocks) which basically lasted until 1980 with the exception of a significant drop in 1973-74 when the market shed no less than 43% (sound familiar?). The second leg of that cycle, namely from 1974 to 1980, was not broad-based, as interest rates were rising to counter inflationary pressures and contract consumer spending. Commodities and consumer staples were just about the only game in town. In today's economic context, it seems that the Fed, no longer limited by the gold standard, is printing money and cutting interest rates to try and persuade consumers to spend, thus stimulating a recovery, whereas consumers are reverting to saving after the real estate and stock market crashes. In addition, banks are reluctant to loosen lending although central banks have cut interest rates to near 0, given their poor balance sheet and loan portfolios.

To get capital flowing again, the US Treasury has created a mechanism (known as "good bank/bad bank") that will repurchase some of the toxic paper held by the banks to strengthen their balance sheet. In due course, lending will resume and corporate and consumer growth as well. If history is a good gauge, the stock market will discount any economic recovery well ahead of time. This is why we cannot let ourselves fall into the pessimistic trap of economic indicators, most of which are lagging market movements.

Wall Street has had more than its share of bad press in the past few months, as was the case during previous crises. Main Street is shedding millions of jobs while bonuses are being paid out to failed Wall Street executives whose firms are being bailed out of bankruptcy with taxpayer money. Something is truly wrong with that picture… I know you can see it. But it seems that the only ones who can't are the executives themselves! Now, this isn't really surprising, is it? They didn't fail for nothing! Blind executives don't usually have good vision… Greed has been their main driver. If President Obama has his way, those bonuses might well be taxed at a rate of 70% to 90%. Other "executives" didn't even bother declaring a bonus… they just took the money and produced false statements for over a decade… and over $50 billion US. Unbelievable! This "Madoff Madness" sure goes a long way to reestablishing investor confidence! One thing is for sure, nobody will deny the desperate need to enhance regulation at all levels. Meanwhile, the continuous flow of negative economic news and the unraveling of massive fraudulent schemes may trigger an emotional reaction affecting your investment behavior. It can be quite a challenge to maintain a rational state of mind in such a depressing environment. But regardless of your reactions, it is now most important to evaluate the possible outcomes given the massive interventions of governments and central banks. To put it simply, there are two possible outcomes to this fix:

1) either it works,
2) or it doesn't

But first, we can say that Mr. Obama and Mr. Bernanke appear fully committed to getting the economy back on its feet, both deploying an impressive financial arsenal: zero interest rates, a $700 billion TARP (Troubled Asset Relief Program), a $1 trillion TALF (Term Asset Backed Securities Loan Facility) , tax cuts, infrastructure spending programs and "quantitative easing", which helps to keep lending and mortgage rates low, are all significant measures that will wind their way into the economy over time.

Stock markets, however, will react and anticipate well ahead of any true results. This is why it is essential to have an idea of which parts of the economy will benefit the most from these interventions. The enormous sums of capital injected into the banking system have to find their way to businesses in order to drive an economic recovery. Without a stabilized and functional banking system, there will be no recovery. Banks are therefore our best indicator of a successful market rebound. But where will the demand come from? What you need to figure out here is where the governments are investing – right now, that would be infrastructure. Given the widespread economic downturn of the last few months, infrastructure spending is now a worldwide phenomenon. Therefore, as the monetary stimulus makes its way to fund these projects, demand for materials and energy will climb again. But the sharp economic downturn has put a halt on Corporate capital spending to expand capacity, and this will result in excess demand, commanding higher prices, leading to inflation.

In other words, if the government's plan works, it will result in a return of inflation, as demand outstrips capacity, leading us back to where we were last July. But what if all these stimuli and interventions fail to restore consumer confidence and investor sentiment? What if inventories keep building and unemployment keeps rising? We would have printed (or diluted) all this money, raised our deficit and grown our national debt for the next generations, without generating a positive return! Wouldn't this raise the risk of civil disorder and political unrest? And what would be the value of the US dollar then?

Inflation is usually driven by an extended economic expansion as demand eventually outstrips capacity and pushes prices higher. But inflation can also be the result of currency devaluation. Many South American countries have suffered significant devaluations in the past as their governments were unable to meet their obligations. A fifty percent devaluation, for instance, would have a 100% inflationary impact. Put otherwise, it would take twice as much money to buy the same product. Some of those countries have suffered in excess of 1,000% inflation in the past. The point here is that if current government interventions and stimulus packages don't work, then devaluation and inflation become more likely.

Accordingly, regardless of the outcome, the odds are that inflation will prevail sooner or later. Given his druthers, Mr. Bernanke would pick the lesser of two evils, namely inflation over deflation, as the former is treatable and curable. But it remains an evil.

The burden of debt

The recent run to safety has driven the demand for cash and short-term paper to unprecedented levels, reaching estimates in excess of $8 trillion US. If and/or when this capital flows back in the market, it could create a "buying panic", forcing short sellers to cover their positions. This short-lived situation should be used to re-balance your portfolios as we believe the government's ability to finance the recovery will become a questionable and popular topic. Let me explain. If equity markets improve significantly

and investor/consumer confidence climbs again, then the Fed will worry about the creation of another bubble. Soft monetary policy will end and interest rates will move up to damper the risk of excess demand and inflation. These actions increase the cost of financing the huge and growing deficit and could potentially stop the recovery in its tracks. On the other hand, as our governments and central banks are determined to intervene as much and as long as it takes to stimulate the economy, the sheer size of the growing deficit will cause concern about financing capabilities. Already the U.K. is having trouble finding buyers for a recent Treasury issue, having placed only 93% of the offering.

If the US deficit reaches $2 trillion in 2009, as predicted by many economists, who will buy all these US treasuries? To put this in perspective, $2 trillion a year is nearly $40 billion a week. In addition, almost 33% of all treasury debt outstanding matures in the 2009 calendar year. As a result, the US is issuing an average of $160 billion a week right now. Although short-term money is costing nearly 0% today, the US Treasury is facing huge refinancing risks; higher interest rates will only increase the debt load.

Japan and China remained very large buyers of US treasuries as long as US consumers kept buying their products. However, with their trade surpluses dropping, their ability to buy US treasuries has shrunk. Two years ago, when the U.S. deficit stood at $200 billion, it was 100% financed by foreign countries, with China alone accounting for approximately one third of that amount. Now that the deficit has increased tenfold, can China maintain its share? Foreigners won’t be able to assume 100% of the load, which is why the Fed is resorting to “quantitative easing”, a fancy term for printing money. The recent Fed intervention to purchase $1 trillion in US treasuries is believed to be the first of many. The extent of quantitative easing will depend on the speed and depth of the recovery. Government tax revenues would then increase again and so would income tax rates, most probably. Consumers’ disposable income would take a direct hit from inflation, higher interest rates and higher taxes. So it will be a long and bumpy road before consumers find their full buying power again, and this will be reflected in corporate earnings growth and the stock market recovery.

CONCLUSION

Inflation is not favorable to all sectors of the economy. As costs edge up, margins are squeezed. In addition, to fight inflation, interest rates tend to move up, further contracting profit margins. Although these actions may be far away, once the first stage of recovery is behind us, your asset mix should be reassessed with a bias towards fixed income investments, with an equity exposure focusing on sectors that are positively impacted by rising inflation (i.e. inflation-sensitive stocks). Gold, energy, agriculture, base metals, infrastructure related industrials and consumer staples all have good pricing power in such an environment.

Over the past 30 years, we have seen interest rates drop from 20% to 0%, and inflation fall from 12% to 0% as well. During disinflationary times, it is very appropriate to increase equity exposure, given cost reductions and margin expansions. As we are entering a reflation mode, we believe it would be wise to increase your fixed income component, even though today's rates are very low. If you can withstand current market pressures, it would be best to increase the fixed income compartment after the first up leg, which will be led by the banks. Then, you might consider shrinking your equity component based on your investment profile, taking into account an inflationary environment risk. Interest-sensitive stocks (e.g. financials and utilities) could become less attractive over time and should be a good source for increasing the fixed income component. Meanwhile, we may be at the beginning of a major consolidation phase given low and attractive valuations and low interest rates for financially sound corporations. Invest in moderation and stick with your game plan.

RECOMMENDED ASSET MIX

INCOME PORTFOLIO			BALANCED PORFOLIO	
Apr 2009	**Oct 2008**		**Apr 2009**	**Oct 2008**
20%	20%	CASH (CSB, QSB, T-BILLS)	20%	20%
50%	50%	FIXED INCOME (BONDS)	30%	30%
10%	10%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	10%	10%
15%	15%	EQUITIES	35%	35%
5%	5%	FOREIGN	5%	5%

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