Newsletter no. 42

"V", " W" OR SQUARE ROOT?

During times of great uncertainty and fear, the stock market usually finds itself at the low end of its cycle as investors shy away. Yet it seems that, time after time, this is precisely the period that stocks are at their cheapest and therefore the risk is at the lowest premium, if not at a discount. This is a paradoxical human behaviour that confronts emotional and rational thinking. Although we can learn from this, it remains a battle between the right side and the left side of the brain, each and every time. Nevertheless, weren't we all baffled by the steepness of the market's fall and surprised by the sharpness of the rebound? Although we surely appreciate the apparent recovery, there is no better time than the present to adjust your asset mix for the next five years. For those who feared but held on, it is now a better time to rebalance and reduce risk. For those who defied gravity and took advantage of low markets, it may be a good time to take in some profits. Economic and financial risks are still very present and worries could be reignited in a flash. This is why a five-year game plan, as it relates to your asset mix, should be revised and respected for that time horizon.

The "plan" should be based on your needs, your "new" risk tolerance and the overall market and economic trends. We will provide you with our beliefs and thoughts as to where these trends are headed, and help you redefine your tolerance level.

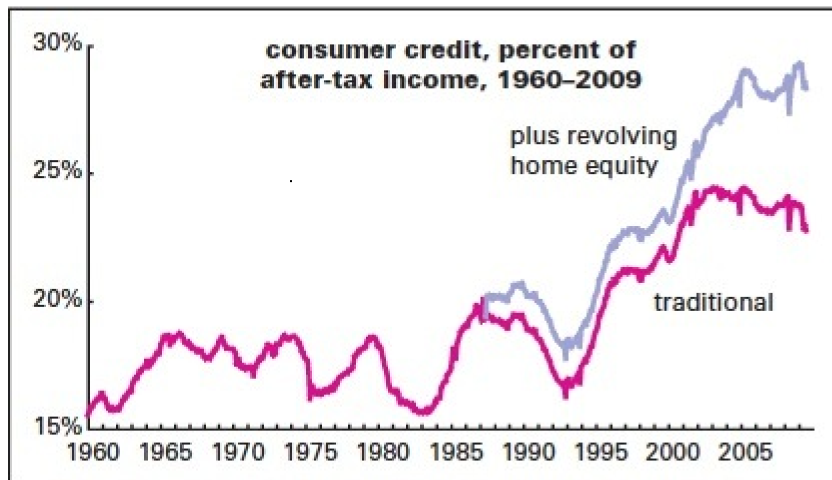
Although no one can be very sure of how the markets and the economy will behave in near future, no one should ignore the facts: the world indices are up generally in excess of 50% from their lows, but so are foreclosures, unemployment, bankruptcies, bank failures and government deficits at all levels (municipal, state/province, national).

Although foreclosure, bankruptcy and bank failure numbers are improving, they are still sliding, albeit at a slower pace. Many state governments are in terrible financial shape and the situation is hardly improving. California, for instance, was issuing, until recently, IOUs in lieu of tax refunds and to pay some suppliers. We are talking here about the eighth largest economy in the world! Unemployment has reached 9.7% in the U.S. A year ago, a 10% unemployment rate was either unthinkable or the definition of an economic disaster. According to last May's issue of The Liscio Report, history shows that financial crisis usually hammer employment, resulting in average losses of 6.3%, followed by a long flat line. Using December 2007 as the onset of this recession, total job losses have reached 4.8%. Based on historic patterns, if we revert to the mean, the U.S. stands to lose another 1.8 million jobs which would propel unemployment in excess of 11%! Remember that unemployment is very costly to governments as it deprives them of tax revenues and raises unemployment claims (a double whammy). Government stimulus packages are put in place in order to avoid such

self-feeding deterioration which can lead to a deflation or depression economic scenario. But the costs of such parachutes will have to be financed for decades to come and may cause the U.S. dollar to erode in value and risk losing its status as the world's reserve currency. This belief is shared by many, including well-known U.S. investor Jim Rogers and Bill Gross who runs the $169 billion PIMCO total return fund.

As for the consumers, these job losses are coming at the worst possible time. Consumer credit as a percentage of after-tax income has reached plateaus we haven't witnessed in decades (Chart 1).

Chart 1 (United States)

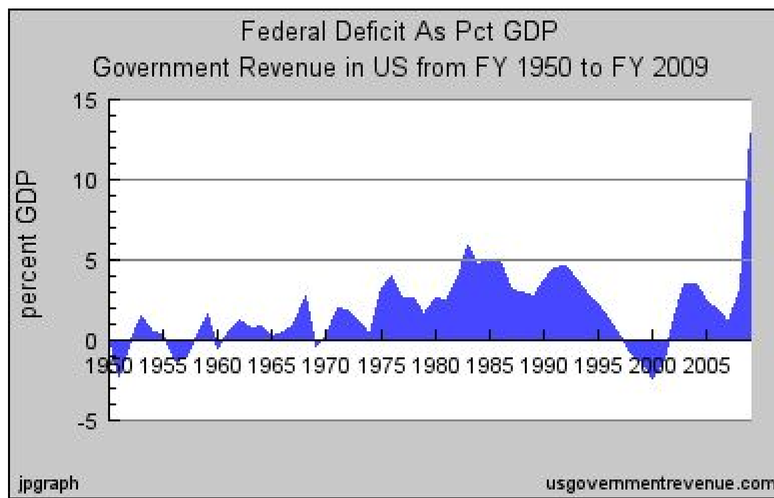


Consumer behaviour is consequently being altered. For the first time in decades as well, we have seen the U.S. consumer become net savers. This may seem the right thing to do, but the Federal Reserve has pushed interest rates to near 0% to encourage spending as an economic stimulus. Consumers may as well direct any savings they have towards the equity markets given the barely inexistent return on deposits. The Fed's strategy has worked quite nicely to date. We have witnessed a very sharp rebound in financial stocks since March, which has allowed some of these institutions to refinance themselves by issuing stock at two, three, even four times the levels they had reached at their lowest point. They can therefore now grow their cash reserves and, possibly, reimburse some of the Central Bank's advances at much less dilutive levels. This, in turn, has helped to restore some confidence in the banking sector and has spilled over to other oversold sectors.

But what about consumer debt? Is any one going to pay for it? How? When? The “deleveraging” period has just started, as shown in Chart 1. It will take a lot of what would otherwise be spending money out of circulation, and that translates into slower economic growth. It also translates into less tax dollars to the government, be it sales taxes or corporate taxes (in addition to higher unemployment costs, as mentioned earlier). So the stock market has rebounded, but how sustainable is the recovery? What happens when the government and central bank stimulus programs come to an end? Some will argue they should be maintained for ‘as long as it takes’… but what about the U.S. budget deficit? And the total U.S. debt? So many short questions that need very long answers. Here is the analogy: the economy has undergone major emergency surgery, and was injected with an extra dose of liquidity, allowing for a successful rescue. Now, the economy is out of the emergency room, but it’s still in intensive care, requiring a daily dose of liquidity to help it stabilize in the hopes of becoming self-supporting once again. Meanwhile, we have to deal with possible side effects that might not be visible at present but that may be more resistant to treatment than the crisis itself.

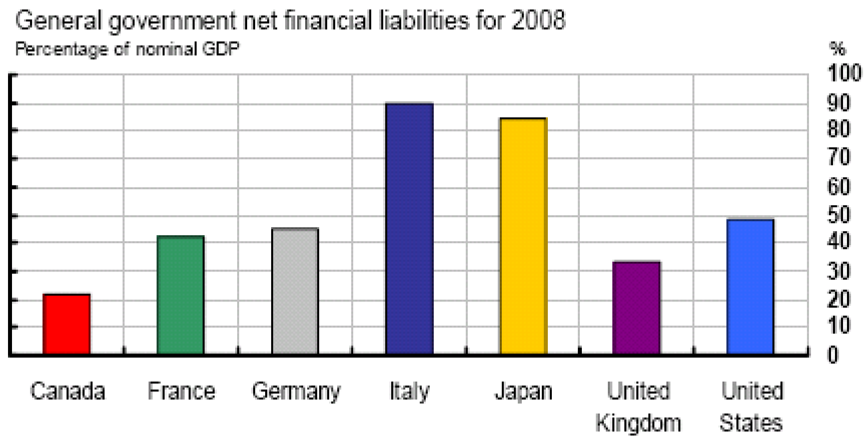
Maybe history can help us in trying to measure this risk. For the current fiscal year, the annual U.S. deficit could reach a staggering $1.8 trillion, or 13% of GDP (gross domestic product). With the exception of the war-impacted years, the highest percentage of GDP the deficit ever reached was 6% (Chart 2). As a comparison, Canada’s projected $56 billion deficit for 2009 represents 3.7% of our GDP. This is what we referred to earlier as the extra dose.

Chart 2



Meanwhile, some of the G7 countries' national debt is growing out of control as a percentage of their respective GDP. (Chart 3) Just imagine what a one or two percentage point increase in the cost of financing could do!?

Chart 3



Now let’s look on the other side of the ledger, where we actually have to pay for all this. But where will we find the money? In the best of all worlds, let’s assume that the current account deficit (also called trade deficit - which means the U.S. buys more imported goods than they export, placing a surplus of U.S. dollars in the hands of exporting countries) is fully reinvested in U.S. Treasuries (approximately $400 billion). That would barely cover 20% of the amount. Then, as American households hoard cash and become net savers, which has recently become the case for the first time in decades, let’s assume they invest all their savings in U.S. Treasuries. That would amount to maybe $500 billion, at best… So we’re still short $900 billion and that is for 2009 only… Any more options? Sure, you can cut spending, the feedstock of the current recovery, namely infrastructure spending, to replace manufacturing jobs lost. Alternatively, you can raise taxes, which would further contract consumer spending and negatively impact the economy. Or you can print money and hope the dilution/devaluation does not drive inflation, and consequently the cost of financing, out of control.

Politically, this last option might be easier to take, at least in the short-term. To let the money supply grow might provide an illusory calming sensation, much like any anti-inflammatory drug would do. It doesn’t cure anything, it just makes the pain go away, allowing you to rest. But any abuse could cause permanent damage. While this short-term, painless solution might appear the most tempting politically, it can be very deceptive to tax payers down the road, as it becomes a very discrete tool that can literally confiscate an important part of the wealth of a country’s citizens.

Countries and their population are caught between a rock and a hard place. Rebalancing the economy is possible, but it will take time. Weaker economic growth is reflected in earnings growth and this in turn contracts P/E (price earnings) multiples. As inflation reappears in subsequent years, caused by subsidized infrastructure development worldwide and/or the continued downgrading of the U.S. dollar, the costs of operating as well as the costs of financing will increase, putting additional pressure on margins i.e. earnings growth. Double digit returns might well be a thing of the past…

Perhaps the market is facing a “square root” type recovery rather than a typical “V”-shaped one. History has shown us how excessive spending and piling deficits can affect the market. Take the 1968 to 1982 period as shown in Chart 4.

Chart 4

From 1968 to 1973, after the gold standard was lifted, borrowed money became more accessible and, combined with a major demographic boom, economic expansion pushed prices higher (inflation) until excess leverage caused an unavoidable collapse in 1974. Once in the ‘’emergency room’’, after a 47% drop, helped by a little “medicine”, the market rebounded, but earnings growth was kept in check as a result of rising inflation (or costs). The S&P500 high of 1973 was not surpassed until 1980 while the TSX broke its 1973 high in 1979. History also shows that the Canadian market outperforms its southern neighbours’ in an inflation-driven economy as its stock index (TSX) is highly weighted in commodities. Today, because of globalization potentially compensating for the strong demographics of the ’70s and ’80s, and the G-20’s determination to solve the world’s financial woes, trillions of dollars are finding their way to infrastructure development projects worldwide. Canada, being a major and reliable source of raw materials, is favourably positioned to capitalize on this expansion. Aside from the financial sector, this is why commodity prices have rebounded so strongly. Just a year ago, emerging countries were paying $4/lb for copper. Suddenly, last winter that same copper was costing $1.50/lb. Today’s price is roughly at $2.75/lb, up sharply, but we wonder how much of that demand was due to stockpiling. If that were the case, then demand will slow and prices may plateau for some time until inventories draw down. That may delay inflation’s return, keep interest rates low, and perhaps buy enough time to get the economy going and finance all that extra debt at a reasonable rate. It could also cause prices to deflate if we have excess inventories. Some oil experts do believe that there is an oil glut out there and that prices could fall as low as $30/barrel by the end of 2009! Who’s right? Who’s wrong? Who knows?

CONCLUSION

In our last newsletter we stated that there were too many variables to conclude that government and central bank interventions were just right to ensure a financial led recovery. Rather, we concentrated on the possible economic outcome given the unprecedented levels of stimuli in the banking system. We concluded that whether they worked or not, inflation was likely to be the outcome. However, inflation could be part of a booming economy, feeding itself on excessive stimulus, or the less fortunate result of a “sharp and swift” devaluation of the currency. While the former could be considered like a curable cancer, the latter would be more comparable with slowly degenerating muscular dystrophy, with costs and pain trending exponentially higher (i.e. stagflation). Consequently, as part of our investment strategy, we suggested focusing on inflation-sensitive investments as a dominant portion of the equity component of your portfolio to better protect your long term purchasing power. Furthermore, we underlined the importance of income-generating equities, where the distribution was perceived to be stable and sustainable. We also encouraged maintaining a 1- to 5-year laddered fix-income strategy. The reality, six months later, is that equities outperformed all other asset classes. Hopefully your patience paid off… This strategy should be maintained.

Your five-year investment plan must take into account your comfort level at the time of the financial crisis. Given that a double dip is a possibility and that nobody is getting younger, preserving your life’s savings should be your focus. We have been fortunate enough to recover a significant portion of our losses and we are facing an economy that has been temporarily fixed by adding more of the poison (debt) that sickened it in the first place. While we know it is not wise to be 100% invested in any one sector, 100% fixed income is not any better, especially given interest rates hovering around 1% to 3%. Central banks are trying very hard to convince us to invest in the market and spend by keeping interest rates so low. Who would have thought that we would be happy to have GICs in our RRSP paying 4%? Maybe we will be happy to get 3% in a year or two! So invest we shall, but very carefully. If you feel comfortable with your current asset mix, make sure the equity component has a diversified focus on revenue-generating stocks.

Stocks that do not pay a large dividend and that carry a lot of debt could be good sources of funds if you wish to reduce your risk and increase your fixed income component. Beware, though. Many of these could provide you with good inflation protection, such as agriculture, gold and base metal stocks. You can adjust your weightings according to your “new” comfort level.

RECOMMENDED ASSET MIX

INCOME PORTFOLIO			BALANCED PORFOLIO	
Apr 2009	Oct 2009		Apr 2009	Oct 2009
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%

Sources:
Gartman Letter
Globe and Mail
Financial Post: Dividend growers drive August 11th, 2009
The New York Barrons
Thomson Reuters
BMO Nesbitt Burns Research
BMO Capital Markets Equity Research Canada
Basic Points
Before the Bell
John Mauldin, The Hole in FDIC Sept. 18th, 2009
John Mauldin, The Statistical Recovery July 24th, 2009 & part 2 August 14th, 2009 & part 3 August 21st, 2009.
John Mauldin, The element of deflation Sept. 4th, 2009
John Mauldin, Investors insight, August 10th, 2009 & Sept 14th, 2009
Fed's monthly consumer credit (G.19) release commercial Banks in the U.S. (H8)
The Liscio Report (Chart #1)
JPGraph usgovernmentrevenue.com (Chart #2)
A Square-Root Recovery (S&P 500 – 1973 to 1982) (Chart #4)
Bank of Canada (Chart #3)
*Excerpts from the Canadian Equities Guided Portfolio, September 2009

The opinions, estimates and projections contained herein are those of the author as of the date hereof and are subject to change without notice and may not reflect those of BMO Nesbitt Burns Inc. ("BMO NBI"). Every effort has been made to ensure that the contents have been compiled or derived from sources believed to be reliable and contain information and opinions that are accurate and complete. Information may be available to BMO Nesbitt Burns or its affiliates that is not reflected herein. However, neither the author nor BMO NBI makes any representation or warranty, express or implied, in respect thereof, takes any responsibility for any errors or omissions which may be contained herein or accepts any liability whatsoever for any loss arising from any use of or reliance on this report or its contents. This report is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities. BMO NBI, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein as principal or agent. BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltee/Ltd. ("BMO Nesbitt Burns") will buy from or sell to customers securities of issuers mentioned herein on a principal basis. BMO Nesbitt Burns, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Nesbitt Burns or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. A significant lending relationship may exist between Bank of Montreal, or its affiliates, and certain of

the issuers mentioned herein. BMO NBI is a wholly owned subsidiary of BMO Nesbitt Burns Corporation Limited which is an indirect wholly-owned subsidiary of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Nesbitt Burns Corp. and/or BMO Nesbitt Burns Securities Ltd.

® "BMO (M-bar roundel symbol)" is a registered trade-mark of Bank of Montreal, used under licence.
® "Nesbitt Burns" is a registered trade-mark of BMO Nesbitt Burns Corporation Limited, used under licence.

If you are already a client of BMO Nesbitt Burns, please contact your Investment Advisor for more information.