Morin Dupont & Associates

Sound advice with outstanding service

Newsletter #50 — *October 2013*

Political Procrastination

(Excerpt)

Morin Dupont & Associates

Sound advice with outstanding service

BMO Nesbitt Burns®

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Pierre's comments

As we "celebrate" or, perhaps should we more accurately say "commemorate" the five-year anniversary of the world's worse financial crisis in history, now's the time to look back and reflect. Take a minute to remind yourself of your state of mind at the time, when you thought you couldn't stand any more weakness, yet the market kept falling… Not a pretty sight, was it? Remember, as well, the discipline it took to stick to your game plan – the right decision, as you find yourself stronger today than prior to the crisis. To succumb to the selling pressure would only have made it more difficult to recover. Yet it is not a happy and joyful experience to see our hard-earned retirement nest egg melt away out of control – certainly a feeling nobody wants to relive…

Looking back, former Treasury Secretaries Hank Paulson and Timothy Geithner, along with present Federal Reserve Chairman Ben Bernanke, were able to navigate the US "ship" through the largest credit crunch in history. Mr. Bernanke's monetary stimulus and programs have allowed the US economy to recover and grow, albeit at a weak 2% rate, through a massive deleveraging process that would otherwise have taken decades to accomplish. These programs have helped to stabilize the real estate market, the single largest asset of consumers, significantly reduce housing inventories and re-ignite household construction, which had fallen behind its long-term median (chart 1).

Chart 1

Source: BMO Capital Markets

As a result, consumer confidence, although fragile, is on the rise, just as home prices and housing starts, all of which help on the job front.

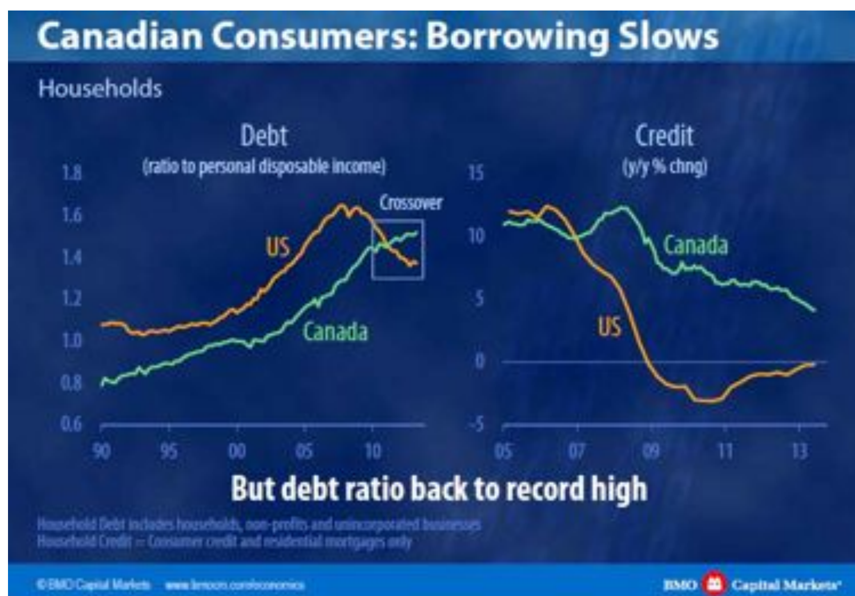
The gap between the average home prices in the U.S. vs Canada has reduced significantly from 60% to 46% in just six months. If history is a good indicator, this spread should diminish and prices should converge in time (chart 2).

Chart 2

Source: BMO Capital Markets

Americans, unlike Canadians, have been strengthening their balance sheets, lowering debt levels and increasing their savings over the past five years (chart 3).

Chart 3



Source: BMO Capital Markets

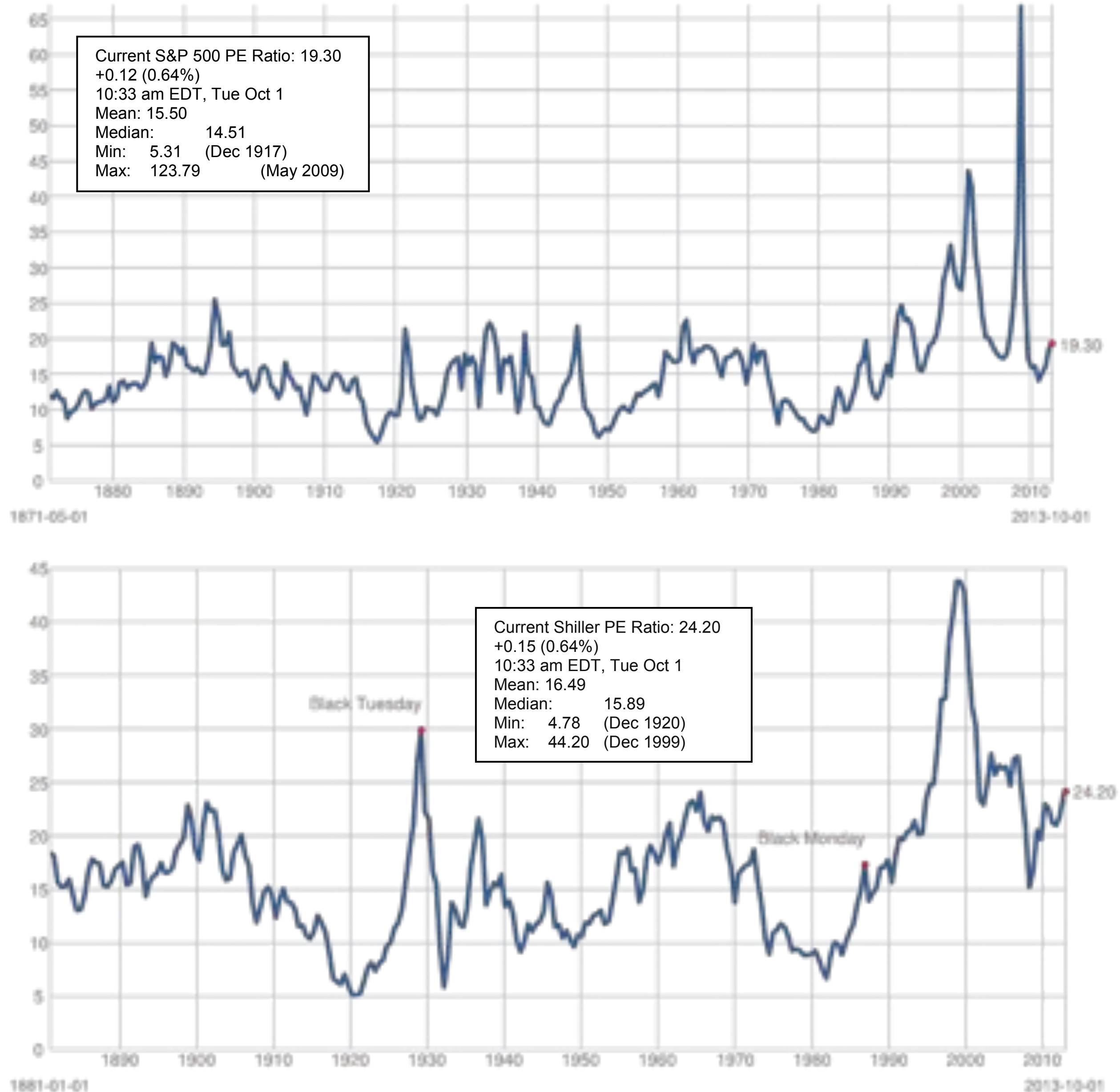
On the corporate side, deleveraging has been massive as well, to the extent where corporate debt, if any, has mostly been locked-in at very low rates. Companies are generally cash rich but have yet to reinvest for growth purposes, as consumers are still resilient. So cash has been used to buy back stock and boost

dividends, which may be good for the stock market but not productive on the economic front for the time being…

The deleveraging process has been hugely accelerated by the measures that these great men put together, but at what cost? In essence, it seems that we have ultimately transferred all that excess leverage to the government's balance sheet which, ultimately, means all of us! The US government debt rating was downgraded from AAA to AA in 2011, and the debt ceiling, determined by the US Congress, is set to be reached by mid-October, just about at the time you will receive this letter. So are we better off? The good news is that the US is the least taxed nation and the largest economy in the world. Nevertheless, no single country can survive solely by relying on an accommodative monetary policy. Somewhere, somehow, sometime, someone will have to bite the bullet… and that is the government as well! Political decisions, although unpopular, will have to be made, and soon. The Fed has done its best and succeeded in preparing a great platform to build upon. But some sacrifices are needed. Alternatives, there are many, but none are prefect and to everybody's satisfaction… that is where compromises are necessary. Although we have written about structural reforms in the past, some of them are worth reviewing (including fiscal reform, new energy policy, infrastructure spending). Beginning now, the Fed has made it clear that it is in the process of slowing its accommodative monetary policy (QE3: quantitative easing #3) and will begin to reduce its purchases of Government bonds and mortgage-backed securities (currently at US$85 billion a month) so the system can begin to sustain itself (also referred to as "tapering"). It will do so in a timely and moderate fashion to avoid and/or reduce speculation and market volatility. But regardless of how and when, a normal yield curve will be the result and that means higher long-term interest rates. Short-term rates, we suspect, will remain very low until the end of QE3.

With the debt ceiling battle just around the corner, it becomes imperative that Democrats and Republicans set a platform on which both parties can build on, allowing for compromises on both sides in order to achieve reform. And reforms are needed in at least three main areas: first and foremost, fiscal reform, followed by energy and infrastructure reforms, all of which could significantly contribute to job creation and enhance consumer and investor confidence. However, unsuccessful attempts to reach some form of compromise and resolution could jeopardize the US's ability to pay its bills and honor its financial and political commitments as they are known today. Prudence is therefore necessary, given the level of risk this represents, as well as the significant optimism and resilience the market has shown, as it's now trading at approximately 19x trailing earnings according to traditional measures. Another, more sophisticated measure – the Cyclical Adjusted Price to Earnings (CAPE) measure created by Robert Shiller (a legendary Yale economist also well known for his Real Estate expertise i.e. the Case Shiller Index) shows the ratio at 24x, suggesting prudence as well (chart 4).

Chart 4



Source: www.multpl.com

This ratio has recently been criticized, however, by another high-profile finance professor, Mr. Jeremy Siegel (from the Wharton School of Business, University of Pennsylvania), who claims the so-called CAPE has been distorted by “changes in accounting standards in the 1990s.” These changes force companies to take large write-offs when assets they hold fall in price although when assets rise in price, they do not boost earnings unless the asset is sold, according to Mr. Siegel. Given that the 2001-02 and 2007-09 recessions brought about huge write-offs, P/E ratios expanded significantly. But as assets regained value, the CAPE remained higher than normal, creating today’s discrepancy. We can therefore estimate that markets are fairly valued, notwithstanding a positive outcome from the current political standoff.

The last proposed fiscal reform was put together in 2011 by a group of six men – three Democrats and three Republicans. Called the "Simpson Bowles" agreement, the plan was rejected by President Obama as it jeopardized the Affordable Care Act also called Obamacare. That agreement has been used as a platform to redesign a new approach to satisfy President Obama's minimum requirements since last spring. We know that the current administration does not want a last minute showdown, exposing the US to the possibility of being in default and having its credit rating reviewed with negative implications. Republicans are currently playing hard ball by saying they will not compromise unless Obamacare is defunded. Without some Republicans support, the budget won't pass and the debt ceiling will be maintained at the current level. The U.S. is expected to run out of cash around October 17th…. Meanwhile the Democrats complain that Republicans are holding the country hostage and have yet to propose an alternate plan of their own! How close are we to an agreement?

The debt ceiling is a manageable hurdle if you have a plan that will shrink the deficit in a timely manner while maintaining economic expansion. The good news here is that we have succeeded in doing just that in 2013 to date. Last February the Congressional Budget Office (CBO) was forecasting a better than expected deficit for the year ending Sept 30th 2013 at $845 billion. The CBO updated to $642 billion at the end of August thanks to the fiscal cliff agreement (December 31, 2012) and the Sequester (military expense cuts, April 2013). (see chart 5)

Chart 5

Source: BMO Capital Markets

That is $200 billion in deficit reduction, with very little tax hikes that generated a 13% increase in revenue (thanks to an improving economy) and a meager 4% cut in spending. There is a lot of room to manoeuver here and, yes, we can make it much better.

Again, tax reform and the debt ceiling are manageable hurdles if dealt with systematically. But to procrastinate further on these issues could set us up for another systemic financial breakdown. Meanwhile, in September, the Federal Reserve Board delayed tapering QE3, probably so as not to add fuel to the fire if there is no progress in the budget negotiations. The government must clean up its act. Zero interest rates and indefinite quantitative easing (QE) won't be sufficient or effective next time around. Government and policy-makers were given one chance to get back on track… There is no room for failure.

As tapering is launched, bond yields should continue to rise, and so will the cost of debt. Interest costs could jeopardize deficit reduction objectives and reduce the government's ability to provide economic stimulus. Tapering is manageable if the government takes action in a timely fashion.

The United States of America have before them a unique opportunity to ensure its dominance as the undisputed economic world leader for the next century if they focus on the future of their nation rather than their personal (or individual) ones. Common sense should prevail!

Fiscal Reform

US corporate taxes are among the highest in the world at 35%. Yet a globalization program encouraging US corporations to invest worldwide and become world leaders was part of the last fiscal reform, implemented under President Ronald Reagan in 1986. Simply put, he provided a tax holiday for all corporate profits earned offshore. US companies expanded their operations into new markets and earned tax-free profits. The re-investment of that accumulated capital was used for further foreign expansion as the money would have been subject to taxes if it were brought back to the US. This clearly changed corporate behavior, and cash rich multinationals were born. Not only were jobs not created in the US, but laid-off Americans workers were replaced elsewhere in the world, resulting in a major loss in revenues for the US taxman. Estimates from $1.45 trillion to as much as $3.4 trillion in cumulative capital is held outside the US, untaxed. This capital could be deployed in the US and help finance huge local infrastructure projects and create hundreds of thousands of jobs. Different proposals have been discussed to repatriate that capital, but in vain. Among them, a repatriation window of a year or two tax free. Another proposal would see a cut in the corporate tax rate from 35% to say 20-25% but applicable to worldwide net business income… This would be great for domestic companies, but not as attractive for multinationals. Perhaps a combination of these proposals might do the trick. Some analysts suggest this could have a neutral effect on government revenues, but the resulting cocooning by multinationals could have a significant impact on the domestic economy. Furthermore, the creation of new jobs would grow tax revenues over time. Some kind of an agreement of that nature would strengthen the domestic economy, raise consumers' disposable income and propel investors' confidence.

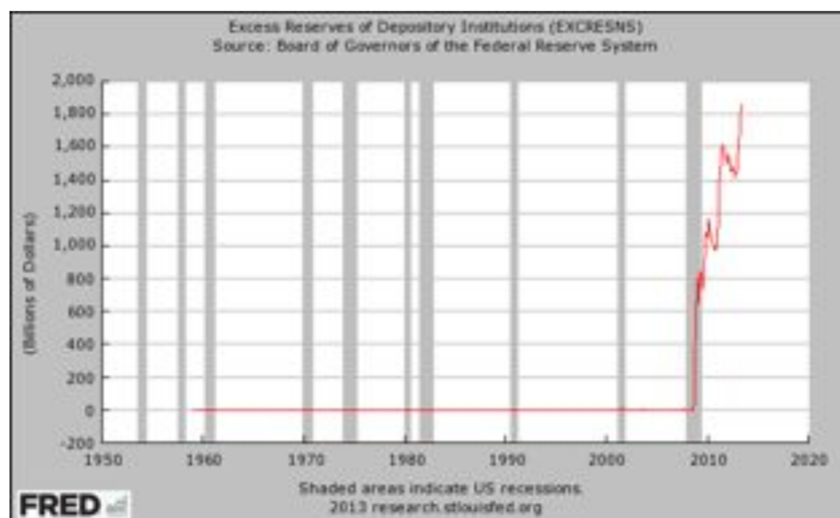
Energy Policy

In our last newsletter, we emphasized the importance of technological advancements
such as induced hydraulic fracturing commonly known as “fracking”. This new approach provides access to enormous sources of fossil fuels, natural gas and oil, sitting in known reserves but un-exploitable until now. Today, not only can the US meet all its energy needs, but the country has become a net exporter. This could lead to lower prices for domestic users and make a huge dent in the US trade deficit over time. Lower energy costs for consumers act like a tax cut: it increases disposable income and stimulates consumption. Furthermore, to increase production and export, there is a need for more transport, pipelines, refineries, port facilities, etc., meaning more jobs, more tax revenues, more consumption, lower deficits and more wealth.

Infrastructure Reform

A new energy policy bodes well for a true infrastructure reform. American civil engineers recently completed a comprehensive assessment of the US’s current infrastructure situation and needs, and gave it a very poor grade of D+ (on a scale of A to F). Impressively, they estimated that US $3.6 trillion in public construction spending would be needed through 2020 to repair/build highways, bridges, dams, water mains, etc. As well, the use of alternative energy sources for cars and trucks would necessitate adjustments in the supply network. In other words, downstream facilities, in addition to regular gasoline, would have to offer liquefied natural gas (LNG) and/or natural gas as well as electric power boosters to meet new demand. Parking areas in cities and shopping malls should provide power supply as well. Much of the financing needed to realize these projects could come from the repatriation of off-shore corporate funds as well as banks’ excess capital (estimated at $1.8 trillion)… provided by the Central Bank at 0% during the crisis! All these enhancements have the ability to create jobs, raise government revenues, strengthen confidence and instill a sense of accomplishment and pride. (Chart 6)

Chart 6



Source: Board of Governors of the Federal Reserve System

There is plenty to be hopeful for, but we cannot base our investment strategy on hope alone. These are not hurdles, but challenges that must be addressed, once we’ve cleared the hurdles!

Canada

Given that 70% of our economy is dependent on the health of the US economy, we must address the state of our southern neighbors, which we have. One would think that we could learn a few things from our American counterparts, but have we? We haven't had a real estate crisis here, so we shouldn't worry about that right? (See Chart 1,2,3)

Apparently, we have a much better and more stringent banking system here than in the States. True, but we also have been lending on record valuations, with only a 5% down payment and the lowest mortgage rates ever. The good news for banks is that mortgages are mostly of the 5-year type, not over 30 years like in the US. However, five years from now, chances are rates will be higher than today, and mortgage payments will increase significantly as well. Unless you are able to make a large principal repayment, you may be forced to sell… and how many others? And at what price? Remember that mortgage rates fell during the financial crisis… five years ago. Many low-rate mortgages will reset in the next couple of years. The good news is that further lending restrictions were introduced by the Bank of Canada, both last year and earlier this year. Meanwhile, mortgage rates have been rising since last May, going from 2.79% for a 5-year fixed rate mortgage to 3.59%, the recent promotion rate for the same term.

As for our national finances, our total net government debt to GDP is back above that 50% threshold, which used to be perceived as the point of no return. Former Finance Minister Paul Martin proved the world wrong on that count as he brought the ratio down from 93% in 1996 to below 30% in 2006. The Great Recession contributed to our misbehavior, although we remain one of the last nations with AAA rated bonds. Today, many nations are well over 100% debt/GDP including Japan at a whopping 230%!

It is important to note, however, that we can be indirect victims of the Fed's tapering policy. As the Fed stems the tide of money flowing into the system, US banks have reversed their foreign investment strategy, causing some emerging markets and currencies to fall sharply. The Philippines, India, Indonesia and Thailand are among those hardest hit. This will impact their economic growth and their energy and commodity consumption levels. As well, the Canadian market (the TSX), is not well diversified, with 70% of its content in three sectors out of 10 – banks, energy and materials. Furthermore, utilities represent a larger proportion of the TSX than the SP500. Given that they are interest-sensitive (i.e. they go down in price when interest rates go up), they are expected to underperform, which is relatively negative for the TSX. It is for those reasons that we have focused mostly on the US market over the past couple of years and we will continue to do so, although with prudence for now…

A favorable outcome with regards to a new US energy policy could cause a glut in some fossil fuels such as oil, and result in a fall in price. This would be favorable to consumers and inflation. For oil producers such as Canada, not so much. It could also significantly impact the value of our Canadian dollar. As Canadians, it is of great importance to continue to diversify geographically while the loony is still near par with the US dollar [We are adding more US selections in our model].

Europe and Asia

Economic momentum is finally gathering speed in Europe, and China has shown impressive numbers, recently bucking the Asian trend. A gauge of China's manufacturing sector, the PMI (Purchasing Managers Index) jumped to 51 in August, a 17-month high, following an above 50 number in July as well (a reading above 50 means economic expansion). In addition, industrial production for August rose 10.4% from a year earlier, topping all 45 analysts' estimates in a Bloomberg News survey, where projections ranged from 9.2% to 10.2%. Chinese corporate leverage is already quite extended however, which could dampen the recovery sooner rather than later if debt levels aren't addressed in a timely fashion. Europe's PMI scored above 50 as well in July for the first time in two years. French business confidence levels rose to their highest in 15 months, indicating that improving demand is helping to support an economy that has stagnated for two years. This is a very good signal, as it provides a momentum from a very depressed base. Meanwhile, interest rates in Europe have come down significantly, and the bond market is no longer freaking out. Although stocks have somewhat recovered after bottoming out, they generally remain very cheap, especially compared to the other developed markets. [We are therefore introducing a European content in portfolios to further expand geographically and to extend our hedging strategy against the growing risk of a weakening Canadian dollar.]

Conclusion:

Investors are confronted with unprecedented accommodative monetary policies, unpredictable levels of government debt, unimaginable political and fiscal gridlocks and a stock market at new all-time highs. What's wrong with this picture? Are we buying stocks because the Fed is printing too much "free" money? Or are we just overly optimistic about all the possible outcomes?

We are finding ourselves in "uncharted territory" and we are fast approaching significant deadlines. Political procrastination is not a solution and politicians are juggling with fire. Therefore, prudence is essential for risk averse investors. Raising cash, allows you to buy at a lower price... If you are fully invested you won't miss out on anything, up or down, but you have to make sure that you can ENJOY the ride!

Our weightings remain very close to our last newsletter, with the exception that we have reduced our utilities exposure to closer to 8%. We've also reduced exposure to the energy sector to 8%. Materials are also down closer to 5%, and telecommunications are closer to 6%.

Meanwhile, we have been increasing our exposure to industrials to 8%, and we are slowly raising our IT weighting to reach 6%. Financials have also been rising to reach 19%, (which includes a maximum 4% real estate exposure) while consumer staples and health care have risen to 8% and 5%, respectively. We are not invested in one sector – consumer discretionary – but are considering a few names here that we will communicate in due course.

In addition, we are introducing a 2-4% weighting in Europe, depending on your tolerance to volatility, as well as a maximum of 2% in emerging markets. As for US exposure, it should represent at least 25% of your total equity exposure.

We believe a little cash on the side will reduce risk and volatility, and allow you to take advantage of any setbacks. Hopefully, we will succeed clearing those hurdles without too much pain, but you can't bet 100% on hope alone… To all the political leaders of the US, be a pro, and don't pro…crastinate!

RECOMMENDED ASSET MIX				
INCOME PORTFOLIO			**BALANCED PORTFOLIO**	
Apr 2013	Oct 2013		Apr 2013	Oct 2013
10%	10%	CASH (CSB, QSB, T-Bills)	10%	10%
50%	50%	Fixed Income (Bonds)	30%	30%
15%	15%	Convertible Debs. and Income Generating Securities	15%	15% -
10%	10%	Equities	25%	25% +
15%	15%	Foreign	20%	20% +

Disclaimer: Subject to an evaluation of the risk profile of individual clients

Sources:

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