

December 2008



Unintended Consequences Yield-Curve Gives a Buy Signal

“In 1961...Fidel Castro announced he was a Marxist and would turn Cuba into a communist country where the government would take over all of the major industries...or as we call that today, a bailout.”

Jay Leno

Maestro – Alan Greenspan, as chairman of the U.S. Federal Reserve Board, was given this nickname after the U.S. entered a mild recession in 2001/2002 following the bursting of the technology-share bubble in 2000 and then by the terrorist attacks in 2001.

History shows that most industrialized nations enter a recession about every seven years, with each recession lasting 6 to 9 months. Greenspan was determined to break that economic cycle. With the U.S. economy facing certain decline, he dropped interest rates 5 percentage points to a multi-decade low of 1%. This brought short-term interest rates to a near-record low relative to longer-term interest rates (a steep, positively-sloped yield-curve). The hesitation of the banks to lend was quickly overcome by the huge profit margins available to them if they did lend. The result is history– a massive, debt-induced consumer boom, which ballooned personal levels of debt though it, did indeed avert most of what would have been a normal business recession.

The unintended consequence of the surge in lending, however, was a real-estate boom which started in the U.S. and quickly spread to much of the rest of the world. Lending money became so profitable that banks were bumping against their allowable upper lending limits. Lenders nonetheless quickly found a way to lend even more money by selling pools of money through ABCP (Asset Backed Commercial Paper) or CDOs (Collateralized Debt Obligations). With so much construction taking place at one time and in so many places, the demand for building materials soared to levels never before seen. Copper and zinc prices rose close to 500% in just five years. Car loans were readily available almost everywhere in the world, causing oil demand surges in places like China and India. And in the U.S., consumers were rapidly switching their vehicles of choice to gas-guzzling SUVs. Crude oil surged 880%, from \$19 in 2002 to \$149 by the spring of 2008.

The unintended consequence of leaving interest rates too low for too long was that the surge in commodity prices led to an upward spike in inflation. Not to worry, though— Maestro was on top of the situation. Interest rates would be slowly increased to contain the inflationary pressures. Unfortunately, the unintended consequence of this was to deflate the oil/commodity bubble and to completely collapse the debt/real estate bubble.

Surprisingly few people predicted such a fallout from the largest credit expansion in global history, not even the new U.S. Federal Reserve Governor, Ben Bernanke. Real estate prices were tumbling; banks were failing; and overly-indebted consumers were finally not consuming.

Response from the Fed? Quickly drop interest rates to reverse the inverted yield-curve and get people borrowing again. Unfortunately, families had over consumed and were now burdened with record levels of debt. Despite the relatively low interest rates, their appetite for debt-induced spending had been sated. As home values declined, many homeowners owed more on their mortgaged homes than the actual value of the homes themselves. Mortgage delinquency payments surged, resulting in bank failures the like of which hadn't been seen since the 1930's.

As the prospect for more bank failures loomed, the U.S. Federal Reserve and the U.S. government injected billions into the U.S. economy. They have bought common shares of banks, preferred shares, and hundreds of billions in troubled assets, all in an attempt to reflate the economy from the deflationary forces that they themselves created.

Most western world countries participated in the debt/real estate bubble and are now all in the same boat. It has become popular in Europe to blame the U.S. for these troubles. But mortgage debt in Britain is, in fact, higher than in the U.S. And we in Canada are just a stone's throw from U.S. levels of personal debt. Most industrialized countries are all attempting the same re-liquidation.

So far, the U.S. Fed has purchased over \$3 trillion of troubled assets, producing a deficit of about \$1.4 trillion. The U.S. has indicated that they will continue to purchase assets, print more money and spend more money until the deflationary forces stop— which brings us to our current economic situation; and, most likely, to yet more unintended consequences.

The expectation, therefore, is for a much weaker U.S. dollar at some point in the future. One unintended consequence of running huge budget deficits is that it sometimes backfires. Canadians remember the early 1990's, when Canada had the highest deficit to GDP in the industrial world. The Wall Street Journal referred to the Canadian dollar as the "Northern Peso." Quebec was threatening to separate. Yet the Canadian dollar rose, from \$0.69 to \$0.89 to the U.S. dollar. Canada's \$40 billion deficit was being financed by selling bonds to foreign buyers, in Canadian Dollars. Since buyers had to buy Canadian Dollars to purchase the bonds, the result was a rise in the value of the currency. The U.S. dollar has been strong of late, as the government issued over \$200 billion per month of bonds, largely to foreign

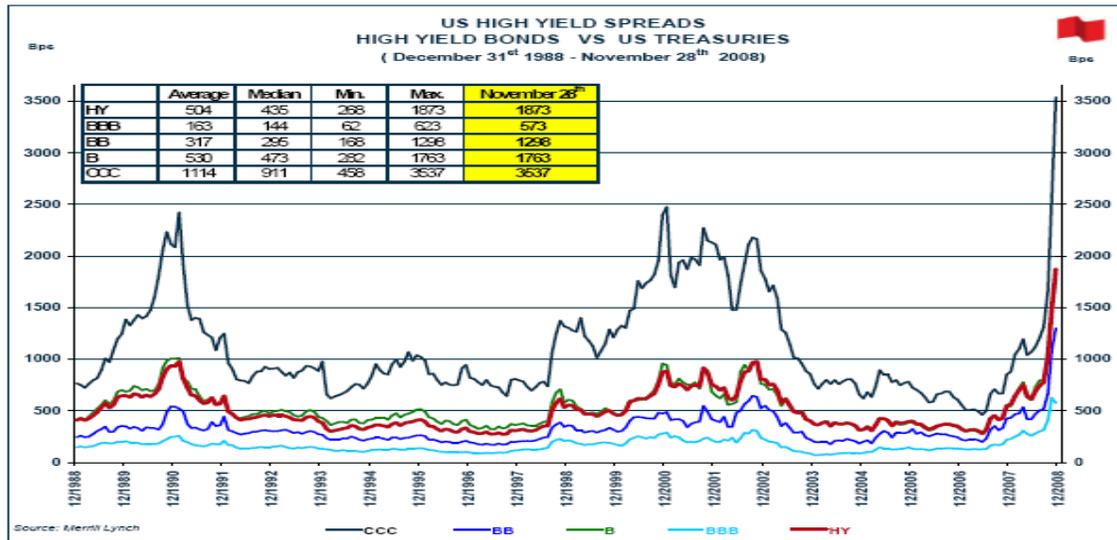
buyers. So the U.S. dollar seems vulnerable, and its decline may well come when no one expects.

In August 2006, I pointed out that the yield-curve had inverted, and was likely signaling a recession down the road. In February 2008, I wrote, "recent data suggest that the U.S. entered a recession some time in November or December of 2007." Curiously, it took the U.S. National Bureau of Economic Research until December 1st, 2008 to decide that the U.S. recession had officially begun in December 2007. Despite the yield-curve's 80% accuracy in forecasting recessions, economists had shrugged it off, as they no doubt will do in the future. From the time the yield-curve inverted, the U.S. stock market peaked 14 months later, up an additional 27%; and the Canadian market peaked 22 months later in June of this year, up 24%. So the predictor was a bit early; but the U.S. and Canadian stock markets are both about 38% lower (as of December 1st, 2008) than when the yield-curve sounded the warning.

Interestingly, the yield-curve flashed a buy signal in October of this year. Despite the U.S. lowering of rates, the banks' interest rates (LIBOR) had not dropped to a positive-sloped curve at that time. Yield-curve indicators tend to be early; but better early than late. The sell signal had been early, just as the buy signal now did not mark the bottom. Today, the prudent course of action might be to use weakness in asset-values to accumulate portfolios of high-quality assets, capable of weathering a longer recession than normal.

Currently, U.S. government deposits of 30 to 90 days (Treasury Bills) yield 0.02%. In an attempt to reflate the U.S. economy, the money supply (monetary base) has been exploding. The result has been a sharp rise in the price of the safest asset class, U.S. Treasury Bonds, which yield 2% to 4% depending on the maturity, as the investment of choice.

Despite the recession, however, investors will not be likely to park their money at these low rates indefinitely. Zero percent interest rates will force investors into taking on more risk. As an example, longer-term provincial bonds yield 5.25%, versus just 3.8% for Government of Canada bonds. Many of Canada's best credit-rated companies yield 7 to 10% in their bonds or preferred shares. I have included a chart showing the recent surge in bond yields as the prices of bonds have dropped because of increased economic uncertainty. Relative to U.S. Government bonds, corporate bonds are at their highest yields since the 1930's. Common shares such as McDonalds, Coke, Proctor and Gamble or Johnson and Johnson have all survived previous recessions and will likely survive this one, too. Moreover, the dividend yield on these global companies is higher than that of risk-free government bonds.



There is no doubt that the economy will remain weak. Employment will worsen and credit conditions will worsen. That being said, stocks and bonds have already dropped on average 30 to 50% as investors factor in the worsening profit outlook.

Obviously no one can predict the exact best day to buy; however, history has shown that portfolios accumulated in the 1974, 1981, 1991 or 2001 recessions had well above average returns three to five years later. Fear is dominating investment discussions at the moment; but fear brings opportunities. As Warren Buffet said, "be fearful when others are greedy and be greedy when others are fearful."

Sincerely,

David LePoidevin, CIM
Senior Vice President
Portfolio Manager
Telephone: 604.643.7073 or Toll Free: 855.643.7073
www.lepoidevingroup.com

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