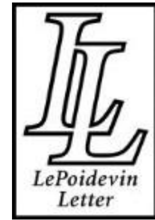
June 2009



Economic Recovery or Deterioration
Canada's Ticking Time Bomb

In March of this year, it was difficult to watch the evening news without seeing black and white photos of the drought or of the soup lines in the 1930's depression. Fear gripped the market as sell orders flooded in, sinking stock prices lower with each passing day. By March 9th, 2009, the S&P 500 was down 57% from its 2007 peak; and the TSX index was down 49% from its 2008 peak. In my March letter, I wrote "the current values of stocks indicate that they are in-line with the lowest valuations of other bear market bottoms." Only three months later, however, the stock market averages have rallied 43%. So where do we go from here?

As I have suggested in my recent letters, recessions tend to destroy earnings. Therefore, a better valuation of a stock may be the relation of its price to its book-value. The current rate of 1.8 times book-value is historically neither particularly cheap nor expensive. Deciding where we go from here, then, depends on one's outlook for the economy, and for interest rates.

Firstly, on the economy. Fear of depression has recently been replaced by an optimistic conviction that the economy is poised to recover. The amount of government stimulus provided to industrialized nations, led by the U.S., is quite unprecedented. And, yes, some of this stimulus has worked. But it can only do so much. Eventually, businesses and consumer spending must also pick up, so that the government can begin to ease back on the stimulus. Unfortunately, consumers' household balance-sheets are severely impaired by record amounts of personal debt accumulated over the previous economic boom. Since 70% of the U.S. economy is derived from consumer spending; and since most consumers' largest asset – their house – is down 30% in value; their spending is likely to remain curtailed for many years to come.

Yield Curve Steepens

Short-term interest rates have moved down to zero; while longer-term interest rates have been rising in recent weeks. Typically, this indicates that the market is anticipating a better economy; and so expectations of a rate increase begin to be built into markets. Currently,

however, something else appears to be at play. Government deficits in industrialized nations have ballooned to levels not seen since World War II. Canada has gone from a surplus, to no deficit, to a $50 billion shortfall. The U.S. is running a spending shortfall of over $1.8 trillion. This shortfall is money which needs to be borrowed – borrowed from foreign buyers. In recent weeks, government bond prices have been falling because the demand for such bonds has been weakening. Supply and demand, once again. Too many bonds being issued and not enough buyers may mean lower government bond prices; and therefore higher interest rates, which in turn, could have a devastating effect on an overly-leveraged economy.

Nevertheless, with short-term interest rates back at zero and optimistic hopes for recovery, money has been flowing to longer-term assets such as stocks, corporate bonds, and commodities.

Déjà Vu

In hindsight, we can see that the zero-interest-rate policy which followed the 2001/02 recession greatly contributed to the subsequent run-up in commodity prices. Remember, too, that there was, in fact, no actual shortage of oil, no rationing of oil – simply speculation that there would soon be a shortage. And many conservative institutions consequently decided to allocate a portion of their portfolios to pure commodity investments. Billions of dollars were pouring into commodities such as oil, natural gas, copper, and gold – which threw the normal supply and demand curve out of balance. By 2008, though, interest rates were back into the 4 to 5 percent range, which was a reasonable risk-free return and resulted in money flowing out of the commodity markets.

Fast forwarding to 2009, we see that interest rates are back to zero, and money is pouring back into commodities. There is now over $2.5 billion in the U.S. exchange-traded fund USO (U.S. Oil), which does nothing but roll oil futures every 90 days. The most active stock in Canada is actually HNU (Horizon BetaPro Natural Gas Bull), which is rolling natural gas futures every 30 days.

What are the Central Banks to do? Raise rates to stop the commodity investors, and risk crushing a weak housing market; or let inflation rise unchecked?

Canada's Ticking Time Bomb

As the decline of the largest asset class (i.e., homes) reduced families' net worth, the downturn in U.S. housing, in general, has had an equally devastating effect as banks have curtailed their lending to consumers.

For similar reasons, we must keep a careful eye on the Canadian housing market, which was in full retreat in late 2008 and early 2009, with the number of transactions and prices both in decline. Now, transactions in the mid- to low-price end of the market have surged, and

prices are going up in most parts of the country. Looking at the borrowing activity tells us why. Firstly, mortgage rates have declined to a historical low. Secondly, 40% of new mortgages are going for 2.75% floating rate, amortized over 35 years. At this rate, almost anyone with a job can borrow $500,000. Furthermore, to qualify for a variable rate, you only need to demonstrate the ability to pay at the 3-year rate, which currently sits at 4%.

Most U.S. mortgages at present are 30-year fixed-rate mortgages. There had been serious problems with a high default rate on the so-called 2/28 mortgages, which start at a low 2-year rate that then adjusts upward after the initial two years. While this category, and other variable mortgages, only make up 15% of U.S. mortgages, they are the root of the default problem.

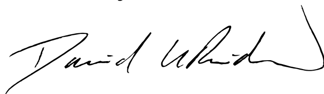
In Canada, 40% of new mortgages have a variable interest rate which floats with the bank's prime lending rate. Currently most banks charge prime plus 0.5%, which starts the mortgage at 2.75%. The monthly payment on a $500,000, 35-year-amortization mortgage is thus at a record low $1855 per month. This is why the housing market has re-ignited in Canada, especially in the mid- to low-end price range. Unfortunately, interest rates cannot stay low indefinitely. And savings rates are already close to zero. As inflation comes back, interest rates will begin to rise, likely in 2010.

A normal 2% inflation would then put the prime rate at 6.75%, bringing that $500,000 mortgage payment up to $3107 per month!

In the U.S., mortgage rates which have adjusted upwards have seen default rates approaching 40%, although such mortgages make up less than 15% of the market. In Canada, however, 40% of our mortgages are potentially affected by variable rates. Consumers who are comfortable with their current monthly payment, but who have limited resources, will have to cope with a surge in their payments. And that could lead to the high default rates experienced in the U.S. Canada – BUYER BEWARE.

In sum, the future is extremely uncertain. If inflation resurfaces and interest rates stay near zero, stocks will likely soar. If the policy response to higher inflation, however, is sharply higher interest rates, then investors will need to be in cash. Investors need to be humble, and not fall into the trap of counting on a pre-determined outcome. I will be closely watching the economic data, especially the U.S. government's ability to fund a seemingly infinite amount of borrowing. Stay tuned!

Sincerely,



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