# Chris Horan, Financial Advisor

## Cross-Currents

December 2012

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients.

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### Introduction

Your advisor has been busy over the summer and fall meeting with your portfolio managers and other industry contacts in Boston, Vancouver, Miami, and yes Toronto. Following are my notes and views from the meetings.

The investment outlook today is as opaque and as uncertain as at any time in my 30-year career. The cross–currents are treacherous and there is unfortunately no safe place for a long term investor to hide. While there are some very strong positives, such as the modernization of China and US corporate financial strength, there are also some strong negatives, such as the deflationary shock from the financial crisis and the long term untenability of the Euro. As Fred Sturm, chief global investment strategist at Mackenzie Financial said, 'There are things out there today that I really like, and there are things out there that I really do not like'.

Fortunately, on balance, we will see that the positives outweigh the negatives. The longer term future is brilliant, although the negatives, as always, promise a rough ride.

### Warning Bells

The world economy is undergoing a major transition. The 2008/9 financial crisis will mark the beginning of the end of 30 years of declining interest rates and its mirror, increasing debt. The collapse of the US banking system in 2008, and the current destruction of the Greek economy have served the warning to both individual households and sovereign governments that there are limits to the level of debt, and crossing the limit has consequences. Like losing everything.

The other warning bell that has rung is that there are limits to the ability of policymakers to avoid or deal with large-scale economic or financial crises. Elected officials pander to short-sighted voters who want luxuries like full employment, free health care, and retirement pensions at 55, without the pain of taxes, recessions, and relentless hard work to pay for it all.

This pandering has driven endless deficits as governments habitually overspend to buy votes (France has run deficits continuously since 1972), and make promises that cannot be kept, such as social security and medical entitlements for the Baby Boomers that cannot be paid for by the next generation of taxpayers.

## Deflationary Shock

The repercussions of the financial crisis are distorting everything in the financial and economic worlds, making life extremely difficult for investors.

Interest rates have been artificially suppressed to zero to counter the deflationary shock of the crisis. Interest rates at zero distort the prices of financial assets. For instance, since bond prices move inversely with interest rates, (bond prices rise when interest rates fall) bond prices have been artificially inflated to the highest in our lifetimes.

As Bob Swanson of Cambridge Advisors pointed out in a recent meeting in Boston, low interest rates have driven the prices of many bonds above their par value. Since bonds mature at par, investors buying these bonds today are assured of capital losses as the maturity date approaches. This will be a surprise to many bondholders.

Ten-year bond yields in Canada are now under 2% (1.6% in the US). After income taxes and inflation of 2%, an investor withdrawing say 5% as retirement income will suffer a loss of capital purchasing power of roughly 50% over 10 years.

The cruel reality of artificially low interest rates means that investors are forced 'out the risk curve' into investments that yield higher cash flow or the prospect of capital gains, both of which entail risks that retired investors are not accustomed to taking. Higher cash flow comes only with higher risk investments such as commercial real estate or corporate bonds. Capital gains come with price variability and obvious risk of price declines.

For investors retiring today these grim facts are simply unavoidable. There is no way out without accepting some level of risk. Dealing with these risks is the central focus of client meetings these days.

## The Good News

Fortunately, as Eric Bushell of Signature Global Advisors said in a recent meeting, 'It may be that risk today is where risk normally isn't, and safety today is where safety normally isn't'. What he means is that risk today is highest in the apparent but illusionary safety of bonds, while safety is in the security of the cash flow from shares in well-managed high quality companies in the US and Canada.

Companies such as Johnson and Johnson (J&J) pay dividends of 3.5%, have $30 billion in cash on hand, very little debt, and have global capability to supply high-quality products that are wanted by households around the world. Equity shares of high-quality companies may represent the best prospects for long term capital preservation, but they do come with market price volatility …

Looking at the broader picture, the US economy continues to grow steadily, if slowly, as consumers pay down debt. Fred Sturm, chief global strategist at Mackenzie Investments said recently the financial system continues to heal, is working through the regulatory changes, and will function more normally. It takes time.

Other good news comes from the Bank Credit Analyst, a highbrow research firm, in their recent Global Overview: their view is that China will continue to grow in the 7% – 9% range over the coming years as they transition from an infrastructure build-out phase to a more consumer-oriented economy. The prospect of a billion people growing their economic activity even by 4% or 5% per year will transform the global economy – and for the better.

It is difficult to exaggerate the positive impact of improving the standard of living of a billion people from pathetic subsistence 20 years ago to something approaching current Western standards in say 20 more years. Improved access to medical treatment, pharmaceuticals to reduce disease and extend lifespan, education to improve knowledge and productivity … the list goes on. Increasing the Chinese standard of living will have an effect on the global economy much like the emergence of the United States in the 19th century.

## US Demographics Positive

Another powerful underpinning to the global economy is the US demographic picture. David Foote, the demographer, has pointed out that the US had less of a baby boom, and therefore less of a baby bust than Canada, so the ratio of retired to working people will be less lopsided, and the tax burden of supporting retired people will be more manageable than say Japan or Europe.

Also boosting the US demographic future is its large Hispanic immigrant cohort. Typically they are hard-working, embrace the value of individual improvement, and have large families, thereby imparting a social and economic vitality which is very exciting for the future.

A third strong positive is lower energy prices. Increased US energy production is a strong boost to industry and consumers alike, particularly for people with lower and middle incomes, because lower income people spend a greater percentage of their income on energy. We are already seeing companies announce major capital investments in US manufacturing based on the prospect of reasonable energy costs. (See "Fallacy of Peak Oil" – page 5.)

The world economic centre of gravity is shifting to China and the US. Europe may well become, as one portfolio manager recently said, 'The world's biggest museum. Wonderful place to visit, but nothing happens there'.

## My Advice

My advice to clients is as follows:

**Bonds:** As unpalatable as low interest rates are, bonds are still required in most older client portfolios to dampen volatility and act as a cash or liquidity reserve for withdrawals. Corporate bonds produce a higher yield than government bonds, but still are only marginally greater than inflation. High-yield (formerly known as 'junk') bonds are highly correlated with equity volatility, don't provide much diversification, so should be used with caution.

Bonds are extremely expensive insurance: prices are in bubble territory for all scenarios but a deflation. Deflation is possible but highly unlikely. Rising interest rates will produce losses on bond prices. Keep bond weightings to the lowest possible percentage to meet your risk tolerance.

**Equities**: Strong preference for high quality companies generating cash flow and dividends. David Slater, manager of the Cundill American Value Fund, said in a recent interview in Vancouver that US bank shares are heavily discounted and selling at 50% of net asset value. They 'are doubles and triples' as the US housing market continues to normalize in the next few years.

Phil Taller, manager of the Universal American Growth Fund, said in a meeting with me that US manufacturing is seeing a resurgence, as many companies are finding that high-value manufacturing such as scientific and medical equipment, as well as sophisticated industrial products with short turnaround times require highly skilled labour available in the US.

**European Equities**: As commented elsewhere in this newsletter, the Euro will likely be 'reconstituted'. European equities will be a once in a generation 'buy' at some point, as share prices there are lower relative to world prices than they have been since the mid-1980's, almost 30 years ago. Hedge funds and other speculative investors have been moving into Ireland for some time.

My preference is to use a manager with global flexibility to participate in the bargains that Europe has to offer. Since I believe there may be another shoe to drop in the Euro saga, I prefer a manager that can be nimble.

## Q&A with Chris

Q: What is this 'Fiscal Cliff' that everyone is so worried about?

A: The term 'fiscal' refers to government spending and taxation policies. Fiscal policy can be 'tight', when the government decreases spending or increases taxes, or it can be 'loose' when the government spends more or taxes less. The 'fiscal cliff' is a series of spending cuts and tax increases totaling about $700 billion (5% of GDP) scheduled to automatically take effect in early 2013.

The difficulty is that a sudden tightening of fiscal policies is not a good idea when an economy is struggling for airspeed, such as the US is now. The Greek economic death spiral is Exhibit A in the growth by austerity plan.

Although the Republican critics correctly argue that trillion-dollar deficits can not continue much longer and are highly addictive, the points the Republicans miss are that the US is nowhere near its practical debt limits, suddenly tight or contractionary fiscal policy risks stalling the plane, and high inflation is nowhere on the radar screen.

The solution will be for Obama to lay out a specific schedule of spending cuts and/or tax increases to balance the budget over the next few years. A balanced budget is a good idea. It isn't even that difficult for most of us – and President Clinton did it in the '90s. It looks like the Republicans will have to cooperate with Obama: they will not want a Republican-controlled House to be associated with tax increases that caused a recession just in time for the mid-term elections.

# The Fallacy of Peak Oil

One of the most interesting economic developments of our time is the resurgence in US oil and gas production. Just when we were sure the US was running out of oil, US crude oil and gas production is now at a 17-year high.

This is big. US oil production is expected to increase by about 30% or 2.6 million barrels a day by 2017. It would then total about 10 million bbl/day, equal to Saudi Arabia's current production.

US oil production is so strong it has sharply reduced US imports, disrupting global trade flows and creating a divergence between the US and European oil prices: the West Texas price of $85/barrel was a full $23/barrel lower than the Brent North Sea price of $108[1]. That is a huge difference. Natural gas is at multi-decade lows.

US oil and gas production is benefiting from technological advances that have opened up vast reserves of well-known but previously uneconomic supplies. As discussed in this newsletter (Running on Empty? [www.chrishoran.ca](http://www.chrishoran.ca) ) the US has many billions of barrels of oil in the Bakken Shale in North Dakota, the Barnett Shale in Texas, and the Marcellus Shale in the Appalachian Mountains, among others. These reserves are on par with Saudi Arabia's (although much more difficult to extract).

The technological advance has been the coincident development of horizontal well drilling and hydraulic fracturing ('fracking'). An oil well can be drilled straight down thousands of feet through solid rock, and then turned, so the well hole is horizontal. Several horizontal runs can be drilled from a single vertical, thereby allowing a large underground area to be accessed economically.

Hydraulic fracturing is where a mixture of water, sand, and 'chemicals' is pumped into the well at extremely high pressure to fracture the soft shale rock. The sand flows into the cracks and holds them open, so the oil can flow out and up the well. (Fracking has been around for many years; in the 1970's oilmen would put dynamite down a well, but the blasts were too small and had only a short term effect.)

Opposition to fracking has been galvanized by the film 'Gasland' whose centerpiece is a man shown lighting his tap water aflame with a cigarette lighter. Protests in Romania, France, and Quebec have halted hydraulic fracturing there.

However, the arguments against fracking are thin: the tap water in 'Gasland' contains naturally occurring methane that has been well-known in local groundwater for years, and has nothing to do with fracking.

The so-called 'chemicals' are nontoxic surfactants and Ph modifiers to control the viscosity and slipperiness of the mixture (like soap), and comprise less than ½ of 1% of the mixture. There are at least 22,000 hydraulically fractured gas wells in the US, and 175,000 wells in Canada, with no serious issues[2].

These new oil and gas supplies are great news because cheap energy is a clear and strong boost for consumers and industry. Not only is the oil and gas industry performing well and generating high-paying jobs, but hydrocarbons are the feedstock for important industries such as plastics and fertilizer.

Finally, the story represents another real-world example of the triumph of optimism and scientific technological development over the dreary negativism which so often captures our attention.

[1] As of October 27, 2012, Financial Times. The global crude benchmark is the Brent or North Sea price. The West Texas Intermediate (WTI) has been the North American reference price for many years.
[2] Canadian Association of Petroleum Producers, Financial Post, March 23, 2012

# Euro Update

The euro crisis, on a rolling boil over the summer, was dropped from the news stream (to be replaced by the US election and now the Fiscal Cliff) when European Central Bank President Mario Draghi promised to 'do whatever it takes' to save the Euro. The euro crisis may have been defused for now, but it is not over. The underlying tensions remain.

Proposals to counter the centrifugal forces on the Euro by centralizing banking regulation and other economic policies are nice ideas but are doomed to fail. The proposals for the financial and political integration of Europe are floated by political elites and earnest technocrats, who believe that they know best and the people will just have to go along.

Financial and political integration may, if it were implemented, actually preserve the single currency. Except for one problem: the people will not go along. Italians do not want to be economically integrated with Greeks or Germans any more than Canadians want to be integrated with the US. As Margaret Thatcher wrote in 1999 before the introduction of the Euro[3], forcing people to go along against their will is difficult in a democracy.

A Greek or Spanish exit need not be a problem. One investment manager I met with recently had just returned from Spain, where he had met with a manufacturer of roofing tiles. The manufacturer was sanguine about Spain leaving the Euro. His company had been in business for over 150 years: through WWI, the Spanish Civil War, Franco, WWII, and the Euro. Going back to the peseta would be just another currency. "People have been buying roofing tiles from us for a long time. Euro, peseta, they will still be buying roofing tiles and we will still be selling them. It will not stop us."

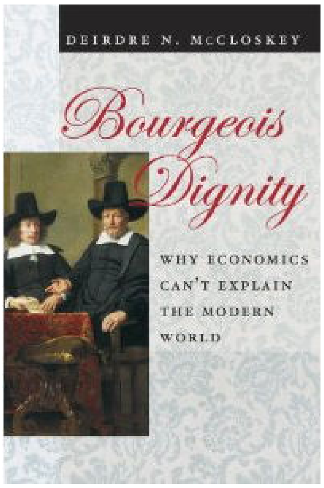
The exit cat is creeping out of the bag. Nordea, the largest bank in Finland, published a white paper recently outlining how a country, like Finland for example, could run a parallel currency as a precursor to converting back to the markka[4]. My understanding from meetings with global money managers is that every organization, including national governments, have people working overtime on 'contingency' plans for converting back to their original currency.

At the same time that people are working out how to leave the Euro, the ECB has relieved the immediate stress. This buys time for the economic healing to continue, and greatly reduces the chance of a disorderly dissolution.

My view? I agree with the Bank Credit Analyst, a pure research firm, who says in their September strategy review that the Euro will likely be 'reconstituted' along more sustainable lines. And with James Morton, manager of the Cundill Recovery Fund, who said at this point it is impossible to say what will happen, how or when. But the more time we have, the greater the likelihood of a negotiated, orderly solution.

[3] Margaret Thatcher, Statecraft, Harper Collins, 2002
[4] Financial Times, October 25, 2012

# Book Review




Bourgeois Dignity: Why Economics Can't Explain the Modern World
Deirdre McCloskey, University of Chicago Press

McClosky observes that the Industrial Revolution improved the standard of living by a magnitude that cannot be explained by typical economic factors such as formation of capital, or foreign trade, or industrial productivity. Income per head increased typically by 30 fold, from about $3 a day to about $100 a day today.

In a wonderfully wide-ranging and detailed way, McCloskey uses examples from economics and cultural history to argue that it was the liberal ideas of innovation and self-improvement available to everyone that made the difference, acting as a multiplier of the traditional factors.

McCloskey is not a capitalist ideologue. She points out that innovation and progress have been consistently resisted by both the political left and the right. For example, the introduction of cotton underwear was resisted for 20 years by the woolen clothing manufacturers who wanted to protect their monopoly, and of course the Marxists who envied the wealth of others for their own.

Deirdre McCloskey is Professor of Economics, History, English, and Communication at the University of Illinois at Chicago.