Chris Horan, Financial Advisor

Great Recession?

October 2010

Assante Capital Management Ltd. – Member CIPF
#3401-130 Adelaide Street West   Toronto, ON M5H 3P5

Website: www.chrishoran.ca
Email: choran@assante.com
Phone: 416-216-6532

Chris has a BA in Economics from UBC, and a business degree from Western (now Ivey MBA). Before joining Assante in 1992 he was Treasury Manager for a Fortune 50 firm where one of his responsibilities was Chair of the Investment Committee of the $65 million pension fund.

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

We are pleased to welcome new clients.

For more information, please call (416) 216-6532 or email at choran@assante.com

Most clients these days appear confident in their financial strategy, but I detect an underlying nervousness not far under the surface. The events of the last three years have people feeling a little skittish, kind of like after seeing The Exorcist, it's easy to be afraid of the dark.

Meanwhile, the news media is pounding the fear for all it's worth.

I spend much of my professional energy pushing against this negative information and the effects it has on the psyches of my clients. I am deeply grateful that my clients share my disdain for the news media's core product. I appreciate that clients are seeking to understand, looking to share my confidence in the future, and looking for rational explanations and a well-thought out investment strategy.

Beginning on page 3 are a number of questions on many people's minds; I hear them in my meetings with you and I see the concern on your faces.

The responses will have two parts: a sound bite of one sentence that will try and capture the essence in the shortest sentence possible, and a second more thoughtful answer of a paragraph or two. You can use the sound bite in a cocktail party, and you can use the longer answer if you want to understand more.

Great Recession?

Many Canadians are under the impression that the economic recession of 2008-09 was "The worst since the 1930's" – that expression having been used in the major Canadian newspapers over 275 times[1]. Was the recession actually the worst since the 30's? Or since WWII? Or even since 81-82?

Data from Statistics Canada says NO.

The table below illustrates Canadian recessions from 1929 to today[2]. Note the Depression and post WWII recessions each absolutely crush the 08-09 slowdown. Nothing since then even comes close, so yes, let's hope it's a long time before we get one of those.

Canadian recessions, 1929 to 2009

Start date - End date	Duration (number of quarters)	Severity (decline in real GDP)
Q2 1929 - Q1 1931	8	-34.0%
Q3 1931 - Q3 1932	5	-17.1%
Q4 1937 - Q4 1938	5	-8.1%
Q2 1944 - Q1 1946	8	-21.6%
Q2 1946 - Q4 1946	3	-4.0%
Q4 1953 - Q2 1954	3	-4.0%
Q3 1957 - Q4 1957	2	-1.8%
Q2 1960 - Q1 1961	4	-0.8%
Q2 1980 - Q3 1980	2	-0.3%
Q3 1981 - Q4 1982	6	-5.0%
Q2 1990 - Q1 1991	4	-3.4%
Q4 2008 - Q2 2009	3	-3.6%

However, not only was the 1953-54 recession deeper, but 1981-82 was twice the duration and 50% deeper in terms of GDP decline than the 08-09 slowdown. In addition, 08-09 was only marginally (0.2%) deeper than the mild and brief slowdown of 91-92.

What about employment? Of the 6 recessions since 1957, the reduction in employment[3] was much greater in both the 1981-82 and the 91-92 recessions than in 08-09. In fact, the 81-82 decline saw almost 3 times as many people lose their jobs.

So, of the 7 recessions since WWII, 4 were as long or longer, 2 were deeper, and 2 had greater loss of employment. On these two measures of economic activity, the 08-09 recession was middle of the road. The recession of 81-82 remains by far and away the worst since WWII.

[1] Fraser Institute, May 2010, p13
[2] Source Statistics Canada, from *Stimulating the Economy*, Fraser Institute, May 2010
[3] Employment data not available for 1953. Economists prefer to use the change in employment rather than the unemployment rate. The # of people employed is based on actual payroll data, whereas the unemployment rate is an estimate of the total # people looking for work, including those who may be looking but aren't eligible for unemployment benefits, divided by the estimated total # people in the workforce. So the unemployment rate is a much more subjective figure.

What was everyone in a panic about? And why did the stock markets decline so much?

The spectacular declines in the markets (58% peak/trough, S&P 500) were the reaction to the virtual shutdown of the US banking system. As with 9/11, people froze in their tracks, and the markets simply reflected that. The abrupt stop also showed up in the GDP data where it was exaggerated by the media. Here's how. Economic data is estimated quarterly or even monthly because economists like to have something to do. But quarterly changes are really boring because they are usually tiny, so they are annualized to give them context.

When a relatively large quarterly change is annualized, it becomes very large and exaggerates the change. In this case the quarterly GDP change for Q4 08, when multiplied for a full year, indicated an annualized slowdown of about 6%.

A GDP decline of 6%, *had it actually occurred*, would have easily eclipsed the recession of 81-82, and easily been the worst since the military demobilization after WWII.

The news media bleated frantically about the worst decline since WWII, conveniently omitting the part about annualized quarterly data, completely ignoring the fact that the decline hadn't actually occurred. Kind of like getting a bonus of $1,000 one day and telling your spouse it was $200,000.

As it turned out, the abrupt slowdown was extremely brief. GDP contracted less sharply in Q2 09 and had begun to expand again by Q3 09.

Ask Chris: Q & A

Q: A Wall Street Journal article July 12, 2010 and New York Times in August with virtually the same headline "Small Investors Flee Stocks" about how the US market has gone nowhere in 10 years and now the baby boomers are upset and selling their equities. I'm worried that the markets won't recover. (Several clients asked this one)

Short answer: Investment professionals know that individual investors are an almost perfect indicator … of what NOT to do. This gives rise to what I call "Horan's low IQ approach" which is simply to identify what the masses are doing, *and do the opposite*.

Longer answer: Any insight from the news media is strictly incidental to their main goal of sensationalizing something, especially anxiety. These articles did a nice job of reiterating only those points that supported the actions of the misguided neophytes 'fleeing stocks'. The articles, as they always do, gave just one side of the story.

The journalist failed to point out that the lessons of history show that individual investors as a group are virtually always wrong. Small and inexperienced investors tend to put their money into whatever has gone up the most, and sell what has already gone down the most. Investment pros tend to do the opposite.

It would have spoiled the story if the journalist had mentioned the other half of the 'equities have gone nowhere for 10 years' story: zero return over 10 years has happened only 2 other times in the last 100 years, 1935 and 1974, and that the subsequent 10 year period returns were greater than 10% per year. Thus the more appropriate conclusion is that a period of anomalously low returns is likely to be followed by high returns. In any case, it is much more difficult to argue that 10 poor years presages 10 more years of poor returns since that has never happened.

Rather than simply regurgitating the rationale of those fleeing, the journalist could have pointed out that the best time to buy is when prices are low: prices are low only when the outlook is poor.

If the outlook wasn't poor, the price wouldn't be low. Only when you truly understand this do you see that the best returns are frequently on investments made, as John Templeton said, *at the point of maximum pessimism*.

Horan's Corollary is 'Bad is Good'.

The article could have also pointed out that 10 years ago, small investors (and many large) were fleeing value stocks and bonds and pouring their money into technology stocks[4], just in time for one of the greatest price implosions of all time.

Journalism's focus on the short term is behind this behaviour that destroys literally billions in investor capital each cycle. Inexperienced naïve investors, aided by foolish salespeople, focus on the immediate past and extrapolate to the immediate future.

The terrible result of this misguided retrospection is that individual investors sold billions of equities each and every month through the bottom in March 09 – after a 58% decline - all the way through an 80% rise in markets. Many investors 'panicked out', selling off shares of great companies at half their previous prices, locking in to zero interest rates on cash, or low returns on bonds, only to watch the markets rise 80% from the March 09 lows.

This shockingly destructive behavior is self-inflicted, and pervasive – it happens every cycle.

Q: What's happening with Greece, Ireland and the Euro: doesn't it look a lot like a replay of the financial crisis?

Short answer: Ireland (pop: 4m) Greece (pop:11m) are too small to matter. There are 20 cities in the world with a larger population than Greece and 28 countries with greater GDP.[5] Germany could buy the entire country, islands and all, if it wanted to.

Longer answer: Normally Greece and Ireland would have been left to default on their bonds. The only reason they weren't is because the European banks do not want to write off their Greek bonds just now – the bailouts had nothing to do with 'saving the euro'. A default by a minor member would have only minimal effect on the Euro (although the poor Greeks would suffer mightily).

The good news is the Greek (and now Irish) debt crises are Exocet missiles across the bow of any country with a deficit spending problem. Voters can plainly see what happens when a deficit gets out of control, and it's ugly. Voters are now motivated to have governments trim unproductive spending, it's why gold is so strong and it's where the Tea Party and Rob Ford are coming from.

We are at the end of the free money game. No more borrowing at rock-bottom German interest rates when you are Greek credit quality. As interest rates normalize from here, higher risk borrowers will pay higher interest rates. Get ready for it.

Q: What about the Euro longer term?

Short answer: Not a problem, yet.

Longer answer: A currency's value is a reflection of a country's policies over time. Intelligent policies that result in economic progress tend to result in a currency that maintains its value, while foolish policies like chronic overspending tend to dilute or depreciate the value of a currency. A depreciating currency is a warning signal that all is not well.

So a currency, like a house, can only be shared by populations that agree on basic economic policies. Otherwise, if one pursues policies that depreciate the currency while the other does the opposite, stresses build up that eventually lead to a breaking point.

---

[4] Many clients will recall the newsletters "Bad Breadth", "Stock Market Bubble" and "Investors Behaving Badly" www. chrishoran.ca
[5] Economist World in Figures, 2008

Economists agree that floating currencies are best because the daily price fluctuations reflect the ebb and flow of the economy and provide the signals to correct the imbalances before the crisis point is reached.

The future of the Euro therefore depends on the willingness of the big 3 - Germany, France and Italy - to have the same monetary policy, i.e. interest rates. As long as they are happy with the same interest rate, the smaller countries can default and even go back to drachmas or punts.

The tension will arise, down the road, when for example the Germans need a higher interest rate to slow down their economy, while the Italians want a lower interest rate to boost theirs. With a single interest rate, the German economy will tend to accelerate and overheat, while the Italians will tend to slow down and stall. Ask yourself how long the Germans will tolerate an overheating economy with its attendant risk of inflation so the Italians can have low rates. (Answer: not long)

Margaret Thatcher[6] was ridiculed by some for her view that the individual populations of Europe simply see things too differently to share a currency, making a successful long term federation unlikely.

Conformity would require countries to either a) voluntarily agree to something against their national instinct or b) be forced by the European Union to conform. As Thatcher pointed out, hoping for the former is a delusion, and the latter is not possible in a democracy.

Q: Aren't things really bad out there still?

Short answer: No. The US economic data is weak. But another negative shock isn't likely.

Longer answer: The unemployment figures are always the last data to recover, because firms postpone hiring until they have to. [One reason is that the workers still on the payroll appreciate the overtime pay.] The media pounded the unemployment 'crisis' into the ground all the way through the 80's recovery to the 90's recession, at which point they began referring to the 'Go-Go 80's'. I guarantee you that the only time the news media will refer to good economic news is to tell you how bad it will be tomorrow.

Here are some facts:

The German unemployment rate is the lowest since 1992. BMW has added a third shift to meet demand: seems the Chinese are buying all the BMWs they can.

The Wall Street Journal[7] reported that AIG, the insurer, has announced plans to repay $20 billion to the Federal Reserve ahead of schedule. The AIG CEO said he is confident that the US taxpayers will eventually be repaid at a profit.

World economic growth is expected at 4.8% for 2010 according to the Economist. Indonesia the 4th largest country in the world, is set to grow at 6%. India and China at over 8%.

Q: Are you saying this will be a normal expansion?

Short answer: No.

Longer answer: The US consumer debt is at record highs and on the surface this seems to court disaster. The US consumer is likely to remain weak, as spending is curtailed by the 'new frugality'.

But the consumer is not gone: the median baby boomer is only about 50, and it is perfectly reasonable to carry a debt load in your peak earning years – kids in school, buying a cottage, and so on. Interest rates are also low, so the actual debt burden is quite manageable. So weak recovery, but recovery nonetheless.

[6] Margaret Thatcher, Statecraft, 1999, Ch x. Written before her stroke, and on the eve of the Euro, she argues forcefully that the Euro will not survive its first serious crisis.

[7] October 1, 2010

Longer term, the US will have to consider the folly of a tax system that encourages mortgage debt with deductible interest, the foolishness of requiring banks to lend to people with low incomes, and the dangers of government guarantees for banks that fail.

In the meantime, great US companies like Boeing, IBM, Caterpillar, HP and Wal-Mart can thrive providing their valuable services to the world economy.

Q: Since you think so little of the news media, how do you suggest I increase my knowledge of investing?

Short answer: Margaret Atwood was sitting beside a surgeon on an airplane. When he found out she was a writer, he said, “That’s really interesting; when I retire, I’m thinking of writing a novel.” To which she replied, “That’s really interesting; when I retire, I’m thinking of becoming a surgeon”.

Longer answer: You can’t learn to play football by reading the sports pages. If you want to read a paper, look for articles that quote someone with experience and serious money invested, but only if the quote is long enough for you to understand the context of the comment. (Be aware that you may only be getting half the quote.) A Q&A format is best. A guest article written by an investment pro is also good. (Understand s/he may be ‘talking up his book’)

A good place to begin to try and understand the complexities of successful investing are the anthologies of essays published by the CFA Institute. The authors are highly respected industry people, mostly written in lay language, and brief.

Classics: An Investor’s Anthology, Ellis and Vertin, Editors, Dow-Jones Irwin, 1989
Or
60th Anniversary Anthology, Financial Analysts Journal, CFA Institute, 2005

Comments, Questions? Please email me at choran@assante.com or call me at (416) 216-6532.