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Interview with Client X

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Many of Client X's questions are on people's minds these days. I thought you might be interested.

Client X was in my office last week for his review meeting. He is fairly knowledgeable, and not afraid to ask difficult questions. Since he has been a client for only about four years, he hasn't experienced a major storm with me.

Q: You said in your January 2007 newsletter that you would not be surprised if the markets experienced a correction. This credit crunch has been brewing for some time. We should have avoided it!

A: I also said that I wouldn't be surprised if there was no correction either. That's the problem: you can't see the future because it hasn't happened yet.

Q: My friend sold his stocks last fall.

A: There are 3 types of people who do that: professional traders, brokers on commission, and people who haven't lost a lot of money yet. Nobody that has actually had money for a long time – 10 or 20 years - advocates trading in and out like that.

The media makes it seem simple, but the evidence is – and there is a ton of it – that your returns disappear. Or worse. You have professional money managers looking after your money.

Q: I don't like paying fees while my portfolio goes down.

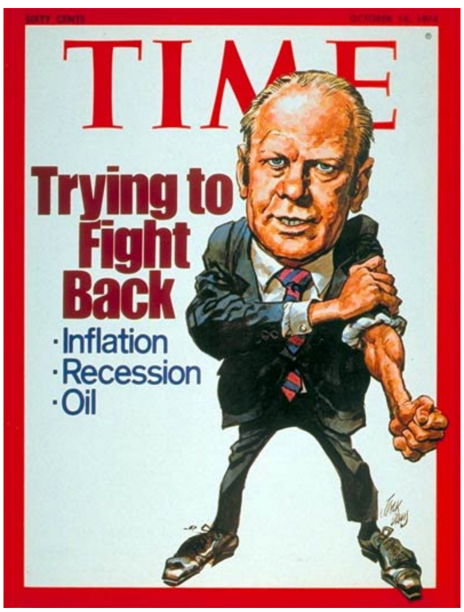
A: It's impossible to invest long term and not have things go down from time to time. What's important is what you do when markets go down. Investors tend to make the worst mistakes at market tops and market bottoms. I add a lot of value at times like these, because I keep you on course. It takes courage to not sell. And not selling is the right thing to do.

New Website

Please check out my new website www.chrishoran.ca. Past issues of the Newsletter are easily available.

Please refer a friend who you feel might be interested.

If you think today's problems are new, try a little game. Cover the President's face on the Time cover below, and ask a friend to guess who it is.



Gerald Ford, Oct. 1974

Q: But the housing crash and banking problems in the US were well known. Everyone could see it.

A: I won't repeat my previous answer.

But I will say that in 25 years in the investment business, there has always been a serious economic problem looming. In 1982 we had interest rates at 20%. In 1987 we had the biggest 1-day market crash ever. In 1990 the housing market started on a 30% decline in Toronto (Vancouver's was worse but didn't start till later) that took 10 years to recover. For 10 years the Japanese banks were insolvent. Not to mention the Y2K panic – people actually sold their houses and investments! And on and on. If you don't see danger, you probably aren't looking. My job is to judge those dangers and steer you through them. Ditto for your money managers.

Q: I've read that the decline in real estate prices in the US will reduce consumer spending and cause a recession.

A: Economists have successfully predicted 7 of the last 4 recessions… Seriously, it is an important question. Research shows that a decline in home price of $1 is estimated to reduce spending by 2¢ to 4¢. So a household whose home drops 10% or $30,000 in price might spend say 3% or $900 less. It is not a big number, and it tends to be spread over several years. We had a 30% reduction in Toronto house prices in the 90s and the economy was fine.

Q: Hasn't consumer borrowing been driving the economy? Isn't the consumer tapped out?

A: There is good evidence that a modern sophisticated economy can handle more debt than in the past, so the historical yardsticks may not be good indicators. Plus, interest rates have been declining for 20 years, so it makes sense that debt levels have been rising.

From a demographic perspective, the median baby boomer is a little under 50, which is a common age to have big loans – house or cottage, education expenses etc. It's the peak earning years, so peak debt isn't necessarily the crisis that the media would have you believe.

Q: You sound dismissive.

A: I'm not being dismissive. The banks' problems are enormous. We may well see another US bank go under, I don't know. But banks do go bust from time to time without blowing up the economy. Royal Trust and Confederation Trust each blew up in the 90s and it wasn't a problem. I'm not being dismissive; I'm suggesting that a bank implosion will not cripple the economy

Q: The papers say there's already a recession now.

A: Maybe so. But what is a recession? It is a decrease in the general level of economic activity. It is not an event or a thing that has a specific consequence. A recession is not a line you cross into some quagmire. Most of the time you'd never even notice anything different, if the media weren't screaming about it.

Q: Sounds optimistic.

A: I'm trying to be rational. Much as the media would have you only see the negative, there are actually positives: the number of sub-prime mortgages in the US is a small fraction of the total, and a third of US homeowners have no mortgage at all. Lower house prices mean more people can afford them. In fact, housing market unit volumes were up 3% in February for the first time since last July, even as prices were down 8% over the prior year.

Mortgage rates in the US are reasonable and going lower, so many households will have more cash to spend, not less. So who is in trouble? People who borrowed a bunch of money at 0% and they're surprised to renew at 5%? Do they think a house is a minivan with dealer financing? The export sector in the US is booming in response to the lower currency. China has a trillion dollars of reserves. Someone just opened a Dubai-Singapore nonstop service.

Q: Isn't the Federal Reserve in the US bailing out the banks and brokers?

A: Short answer: 'No'.

There's no bailout. Yes, the banking problem is very serious. Bear Stearns was the 5th largest US investment bank until it collapsed in March. Lehman Bros. may be next. We just don't know.

But the Fed is not giving 'get out of jail free' cards. Bear Stearns shareholders have suffered catastrophic losses – the shares went from around \$150 to \$10. As they should have.

The Fed is highly sensitive to the issue of 'bailing out' the risk-takers. He is orchestrating the destruction of the bankers who got themselves into the pickle, while at the same time keeping the banking machinery running.

Q: If you don't think US housing is a big problem, then why is the Fed so anxious?

A: Banks are critical to a modern economy. The banking system's main job is to match up savers with borrowers. If savers lose their deposits, or if people can't borrow, the system stops, and that would be a major problem.

The Fed is making cash available to banks because the normal interbank lending markets are not functioning properly. He is trying to keep the system running. He has his foot to the floor because the engines need fuel.

Q: Isn't all this liquidity stoking inflation? Inflation is going up fast. With oil at \$100 and grains all up by huge percentages it has to get worse.

A: Short answer: No, inflation is not a danger at this point. When you take out oil and foodstuffs, core inflation is steady. Long bonds, the most sensitive indicator, are telling us that inflation is not in the cards. Deflation is the more immediate risk, according to the Bank Credit Analyst.

Q: Why take out oil and food out of inflation? Sounds like weaseling. If prices are up, that's inflation!

A: No it isn't. You must differentiate between a price shock and general inflation. They may look similar, but they are very different animals and they call for very different responses.

Oil up 25% and a doubling of wheat are price shocks. They will only drive up the price of other things in proportion to the amount of oil or wheat in the item. After that, prices will stop going up. That is not inflation.

Oil and foodstuff prices are increasing because of demand/supply changes unique to those particular markets. The emerging economies are improving their diets, and modernization of their economies requires energy. Farmers will respond by growing more, and foolish Westerners will stop burning corn ethanol in their cars.

True inflation, on the other hand, is a broad erosion of the value of money. It is caused by the money supply growing faster than the economy. If you have more dollars for the same size economy, each dollar is worth less.

Q: Isn't that what's happening now? The Fed is flooding the system with money.

A: Price shocks such as a bursting bubble or a banking liquidity crisis reduce the amount of money in the economy. They are deflationary. The antidote to a deflationary price shock is to drop interest rates and increase the money supply to help get cash back into the economy. True monetary inflation is caused by too much money floating around. The correct policy response is higher interest rates to 'mop up' the cash. The Fed is doing the right thing by lowering rates.

Q: But what about the longer term?

A: The concern over inflation is valid. The US Fed and Governor Carney in Canada are both very sensitive to the inflation risk that accompanies low interest rates. They will be raising rates as soon as possible when this banking problem settles down, to keep inflation in check.

What would worry me is if the Fed was saying that inflation was the problem now and he was raising interest rates, for example. Or if the new US president abrogates the various free trade agreements and implements protectionist tariffs – those would be colossal mistakes.

Global free trade is the single most important policy contributing to the rising standard of living in the world today. Forget this crap you hear about job or environmental standards – trading with the less-developed nations is the only way to get them to the level of prosperity they need so badly. As their standard of living improves, they will improve their other standards as well…

Q: Okay. What else?

A: Jim Pattison just bought control of Canfor, a West Coast lumber company. Prem Watsa, no dummy either, just made a $350 million investment in AbitibiBowater, an East Coast pulp company. This is the time to be buying, not selling.