# Chris Horan, Financial Advisor

## Road to Recovery

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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

Assante WEALTH MANAGEMENT

March and April were a relief from the investment nightmare that began in September and staggered from bad to worse. In February the crisis seemed to be overwhelming the authorities and the US seemed to be slipping into chaos. The CEO of a money management firm wrote: 'This has been the worst year in anyone's investment career. Everyone is losing sleep'.

So far every step of the credit crisis has proven far more complex, far deeper, and more intractable to resolve than anyone had imagined. What was a purely financial problem barely six months ago has infected the broader economy and resulted in a worldwide, and severe, economic contraction.

Japan is taking it on the chin: real GDP contracted at an annual rate of 12% in the 4th quarter of 2008, according to the Bank Credit Analyst, a high-end research firm. A steep decline over a 3-month period is one thing, but even more significantly, Japan's exports declined by 49% over the full 12 months to February 2009. As the BCA says, the drop 'defies belief'.

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.

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

## Edge of the Abyss

The US and UK economies are skirting the edges of a debt deflation. A debt deflation is where deflationary forces increase the real amount of outstanding debt by reducing incomes and asset values. Attempts to sell assets and reduce debt forces asset prices down further, increasing the relative debt load. A downward spiral ensues.

There is a small chance that the US loses control of the situation and a US$ currency crisis occurs. The Fed may try and keep short rates low to spur the economy, but longer-term rates are set by the market, so it is possible for longer rates i.e. 5 yrs+ to go sky high if people with money refuse to invest in a depreciating US$. Most analysts assign a very low probability to this scenario, because it is not in China's, Saudi Arabia's or Germany's interests to have the US currency go off a cliff. It may be a low probability, but it lurks.

One notch up from the above scenario, there is a chance that the US financial and economic crisis continues to prove more difficult than expected, and the economic and financial situations continue to deteriorate for longer before recovering in say late 2010. In this scenario, US corporate earnings would continue to fall, reducing the underpinning of the markets. Investor pessimism could then push valuations lower, which would crush asset prices further. In this case, major US markets could experience another 25% downside – below the March lows - before ultimately bottoming.

We may not be out of the woods on this. The major US equity markets breached very important technical/psychological support levels in late February by falling below the previous bear market lows of 2002/3 and 1998. Fortunately, the markets recovered fairly strongly later in March, so we have stepped back from the brink.

My view is that the positive factors detailed below will overwhelm the negative shocks and lead to recovery. We need to see at least one down leg of 10% or so in the major market indexes that stops without going below the early March low. An up leg that carries the indexes above the Jan 09 high would be a good sign. This will begin to establish a pattern of 'higher lows' and 'higher highs' that will start the next uptrend.

## The Positive Case

The positive case is that the authorities are committed to doing whatever is required to get the financial system operating properly again. A debt deflation is not an acceptable outcome and worldwide authorities have committed to extreme measures to get the financial system running.

Comparisons with the Great Depression and with Japan's Lost Decade are popular with the media, but they overstate the case. Those two historical events were the result of policy errors, discussed in earlier letters (www.chrishoran.ca) that are not being made today.

One key to solving the financial part of the crisis is that bank losses need to be written down over a period of time, not all at once, says Dan Bubis, manager of the CI Canadian Investment Fund. This will allow banks to stay healthy as they absorb losses; in addition the great majority of banks, including the smaller US banks, have adhered to lending basics and are in reasonable shape.

The key to the economic part of the crisis is confidence. The financial crisis has shattered investor and consumer confidence, and for good reason. However, confidence can return as quickly as it left. All that is required is for the 92% of the population that is still working (down from 95% 6 months ago) to realize that they are still doing 98% of what they normally do, and the economy will recover.

It may be difficult to believe, but the crisis will end, it is just a question of when. As of late April, the toxic asset problem seems to be contained. A number of important financial indicators are swinging back from the red end of the dial. The TED and LIBOR/OIS spreads, and the Market Volatility Index (VIX), proxies for risk, have fallen significantly from their September/November 08 panic peaks, indicating the crisis may be passing its critical phase.

The money markets are beginning to move. Companies are successfully issuing bonds (debt) to institutional and public investors, and the very short-term money markets (commercial paper) are moving again, as well.

The actual declines in many important economic data such as total employment, real GDP growth, durable goods orders, corporate operating earnings, and particularly non-financial corporate earnings, are not as much as the 1982 recession, according to the BCA. It's a recession, not a depression.

Other positive points are:

**Oil Prices**. Oil prices have fallen about $100/bbl from the peak of less than a year ago (hard to believe). World oil consumption is about 80 million bbl/day, which works out to about $8 billion per day in savings (or lost revenue if you're a Saudi). That's about $240 billion per month saved by consumers. Those are big numbers.

**Interest Rates Low**. Consumers can refinance debt at significantly lower rates, and gas prices are much lower than a year ago, thereby freeing up cash flow to either spend, save, or buy a rental property at a foreclosure sale.

**Housing and Auto Rebound**. Light vehicle sales in the US have been running at an annual pace of 10 million units vs. a normal level of about 17 million, while single-family housing starts in the US have fallen to a post-WWII low of 350,000 units vs. normal of 1.2 million says the BCA. Nick Murray, long-time industry commentator, reports that, at current sales rates, the average US car would be on the road for 25 years. Dramatic declines such as these indicate a potentially powerful rebound in sales – and confidence – as demand recovers to more normal levels.

Housing prices have fallen 29% from their peak in the US and are now 10% undervalued relative to incomes, reports the *Economist*, and February data showed an 'unexpected' increase in housing transactions. Qualified buyers are beginning to step up and invest in distressed properties that are good value.

**Cash Mountain**. The amount of cash in money market funds in the US is now equal to the entire value of the US equity market. Cash in MMFs has not equaled the stock market capitalization since records began in the 1960s according to the BCA. This cash is earning less than 1% and in many cases zero, so the incentive for it to find a home with a better return is strong. This cash will be circulated into the financial system via bank loans, mortgages, and investments – to qualified borrowers and businesses, and into the investment markets.

**Valuations**. This is probably one of the most important points in this newsletter: the stock markets are as undervalued, and the bond markets as overvalued, as they have been since 1982, more than 25 years ago, according to the BCA. We aren't out of the woods, but we are looking at one of the best times in our lifetimes to be buying the shares of great companies.

**Dividend Yield**. The dividend yield on the US equity market (S&P500) is now higher than the yield on 10-year government bonds, for the first time since the '50s. In Canada, many stocks are yielding 6% vs. term deposits at 1%. Investors should be asking why they would sit in a deposit at 1% when they can earn a dividend from the same bank of 5% or 6%.

## Looking Forward

### Inflation and Interest Rates

In the short term, interest rates will likely be low – very low – possibly for the next year, until the economy gets rolling again. As the economy gets traction, the deflation fears will recede, the risk will flip from deflation to inflation.

For the next few months the headline inflation numbers will be negative. The media will have a field day with the 'spectre of deflation'. However, just as last summer's headline inflation surge actually reflected the oil and commodity price shocks and was therefore not true inflation (as this newsletter pointed out), this summer's negative inflation numbers will reflect last year's high oil and housing prices falling out of the data. The core inflation data will likely remain benign.

As the crisis fades, the Fed will have to increase rates smartly to mop up all the dollars and arrest inflationary pressure. Because of the mechanics of the money supply, this means higher interest rates. In addition, because longer term bond yields are set by the inflation-sensitive market, longer bond yields will rise as well.

**Investment Strategy**

Short term: It is possible that the crisis persists. In this case, it is possible for investor despondency and earnings contractions to drive equity markets down another 25%. Investors must be prepared for this. Investors who are not willing or able to accept this potential volatility have no choice but to increase their weighting to cash. (Keep in mind that this is no different from normal: the markets can drop at any time by 25%.)

Longer-term: Looking out 6 months and more, investors will want to be prepared for the market recovery, which will likely precede the economy by 6 months. This will mean reducing bonds in favor of dividend-paying stocks for income and conservative portfolios while growth-oriented portfolios will want exposure to resources and small company stocks. Resources, particularly energy companies, have been showing significant strength to date in 2009 and look likely to lead the market. Small-cap stocks have been hammered and are therefore likely to rebound strongly as economic prospects brighten.

Bonds do well when interest rates fall, and conversely bonds lose value when rates rise (because they've locked in a low interest payment). As we move forward into inflation, long-term bonds could suffer price declines that make 1994 look like a picnic. In the inflation of the 1970s long bonds lost more than half their value(1). As one money manager said to me recently, 'The time you want to hold onto a long bond is about the same amount of time that you hold a grenade after you've pulled the pin'.

Borrowers should consider that interest rates could be into double digits sometime in the next few years. My advice is that borrowers should keep mortgage amortizations at about 12 years or less to reduce rate sensitivity. Do not be seduced by today's low rates.

Meanwhile, the pessimism in the equity markets is so strong that any shred of optimism is met with derision. This presents opportunity, says Dan Bubis, who has been buying RIM, CISCO and Apple. These firms have great growth prospects, and the latter two sit on 'Gibraltar-like' cash hoards of $30 billion and $26 billion. Ever the contrarian, Bubis has also used the despondency in the auto market to buy shares of Magna, an auto parts supplier. GM and Chrysler's places will be taken by others, and Magna will supply them with parts, says Bubis.

(1) (SML Index 10-yr RoR 1981= -5.75%/yr, Towers Perrin 13b)

## Ask Chris: Q&A

*Q: Shouldn't a retired investor own bonds?*

The best asset class of the last 10 and 20 years – bonds – will not be the best-performing asset class of the next 10 years. The best investment advice – for retired investors to own very few government bonds – will go counter to popular perception and rules of thumb regarding risk. Investors will want equities that pay good, and high, dividends and also provide growth. Real assets such as resources and real estate also tend to do well with mild inflation.

Retired investors should include a large weighting in a professionally managed balanced income portfolio of blue-chip equities, income trusts, and corporate bonds. Short-term bonds present very little risk but practically zero return even before tax and inflation.

*Q: Why Didn't You See This Coming?*

The level of investor frustration today is understandable. It's difficult to have a decline of hundreds of thousands of dollars – or a million – in your portfolio. I sympathize.

But consider that Robert Rubin, former US Treasury Secretary, previously CEO of Goldman Sachs and a long-time director of Citibank, is one of the smartest and most experienced financial people on the planet. He has been at the pinnacle of financial intelligence – data and IQ – for many years. Yet Rubin wrote in a recent letter to the Citibank board:

"*My great regret is that I and so many of us who have been involved in this industry for so long did not recognize the serious possibility of the extreme circumstances that the financial system faces today*."

If Robert Rubin didn't see this coming, then do you really expect your advisor or anyone else to have seen the future? But it goes beyond seeing it coming.

At any point in my career there is a major issue on the economic radar. The concern *du jour* always has the potential to severely damage the world economy. The Japanese banking system was insolvent for most of the 90s for instance. Russia flirted with anarchy under Yeltsin. The Y2K bug, SARS, Washington snipers, 9/11, smallpox, bird flu - each of these had the potential to spin out of control and become a major economic disaster. The Japanese banks weren't even on the public radar – so investment pros had to fret to themselves about it.

With each of these issues, there is always a range of opinions, backed by credible sources, as to which way the problem will evolve. Each opinion is backed up by data and experience, and is cogently argued.

The problem is that it is impossible to say who is correct until after the fact. As Robert Persig wrote in the classic *Zen and the Art of Motorcycle Maintenance,* 'Things are only simple after you have figured them out'. After the fact, of course, one of those opinions will be the genius, the other isn't.

**But wasn't it obvious?**

I can assure you that the implosion of the US banking system was an extremely remote possibility. Even as late as August 2008, when it was still just a 'liquidity crisis', if someone had told you that within 8 weeks 7 of the 10 largest US banks would be insolvent and markets would fall 50% in 6 months, you would have thought he was a nut bar on the fringe.

The question of how the US consumer would adapt to rising interest rates has been studied closely ever since interest rates were lowered during the tech stock crash of 2002. It was widely acknowledged that consumers in total had significant debt loads, so the question of what happens when rates rise was obvious. The *question* was obvious. The answer was not.

There was tons of data that showed that consumers adjust to housing price declines, and that gradual interest rate increases shouldn't be a problem either.

And many people are surprised to learn that government policy was explicitly behind the relaxation of lending standards in both Canada and the US – that led to the sub-prime problem in the first place. Please see 'A Brief History of the Credit Crisis'(2).

But anger is misplaced. Anger – at your advisor - at having your portfolio decline indicates a misunderstanding of the credit crisis and also of what you are paying your advisor to do.

It is not the advisor's job to see the future. That privilege is simply not available to any of us. An experienced sea captain would never promise a ship-owner a storm-free passage across an ocean. The experienced captain will promise the owner that if he is unable to avoid a storm, he will use all his considerable experience and skills to handle the ship in such a way that the passengers and cargo have the best chance of safely making their goal.

The measure of a good captain is not a storm-free passage. That is beyond our control. The measure is how the ship was prepared and how it is handled.

What are the signs of good advice? Every client has a written estimate of potential downside risk. So a decline is no surprise. Every client over the age of 50 has bonds or has discussed bonds in the portfolio. The bond allocation of your portfolios is actually in bonds, not index-linked notes or other high-fee synthetic instruments most of which have proven useless or worse. Not one client has investment leverage. Your core investment managers are excellent, experienced, conservative men and women managing your money as they do their own. Most of your portfolios have suffered declines far less than the market averages.

Please also know that I deeply appreciate being an investment advisor today. These are extremely difficult times and good advice is much less common than you might think. This crisis is what I have been preparing my entire career for. Many of you have friends and family that are in need of good advice. I would be happy to hear from them at any time.

The waters today are as treacherous as anyone alive has seen. This journey we are on is a one-way trip that nobody has been on before. There are no maps. Decisions made in the next few months will have repercussions on your financial position for years. In my view the pessimism is overdone, and lifetime opportunities are at hand for investors.

(2) http://www.chrishoran.ca/pdf/Brief%20History%20of%20the%20Credit%20Crisis.pdf