Chris Horan, Financial Advisor

The Credit Crisis, and Optimism

November 2009

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

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

A little more than a year has passed since the beginning of the most terrifying episode in financial history. The Lehman Brothers and AIG thermonuclear detonation under the US financial system was, like 9/11, a previously unimaginable event that unfolded in slow-motion. Six very short months from September 15th to the middle of March 2009 took us with no exaggeration to the edge of complete financial chaos.

The crisis destroyed a larger proportion of household wealth than the Great Depression, according to McKinsey Global Institute, a think tank.

Now, 6 months later, we have left the panic behind. The markets have recovered 85% of their pre-Lehman levels, and the volatility indicators have settled down. Money markets are operating reasonably normally, banks are announcing earnings again, and the US and Canadian central banks are shutting down their emergency funding lines. Plenty of bullets found their marks, but we are moving forward again.

Importantly, the long-term trend (200-day average) on the major markets has turned positive. This long-term trend changes infrequently, so once a trend is established it tends to move in that direction for a couple of years at least. So things are looking up.

Investment Outlook

Government bonds have done well through the crisis as rates have dropped to generational lows. Bonds may seem attractive now vs. the awful price volatility in the equity markets, and investors are piling billions into bonds, according to the industry data. However, since bonds do not do well as interest rates rise, the good returns from bonds over the last 5, 10, and 20 years stand no chance of repeating.

My advice: resist the temptation to reduce risk in your portfolio. That horse has left the barn. If anything, we want to consider increasing exposure to equities as the recovery gets under way. The yield on corporate bonds is much higher than government bonds, so corporates represent a good opportunity for significant return. If we must have bonds in a portfolio, favor corporate bonds.

The crisis has also caused a 'behavioral convulsion', according to JP Morgan, as consumers cut spending and boosted savings from <0 to 5% of income. Although the US consumer may be weakened, the good news is that banks can now function as financial intermediaries again. A bank's job is to take deposits and lend the capital out to qualified borrowers – at interest rates appropriate for the risk. The point is that lending money is a tricky business but if they do it well, risky loans can be profitable. An oligopoly in Canada helps, too.

Canada is in excellent shape. Because Canadians accept high taxes, our governments can afford some countercyclical deficit spending. A strong C$ allows inflation and interest rates to stay low. The continued and gradual decline of the US dollar is good for the economically powerful US export sector, which will take up some slack from the US consumer.

In a bear market the seeds are sown for the next market cycle as the new leaders emerge from the maelstrom of the decline.

The prices of metals, oil and other commodities, and emerging markets are recovering strongly. The mines/metals sub index on the TSX bottomed in December, 3 months before the rest of the market, and has recovered to its September level. Emerging Markets are the top-performing market sector in the world this year to the end of September, up over 39% (MSCI C$)

In addition, the December bottoms in metals, oil, and commodities (CRB Index) were significantly higher than past bear market bottoms in 2001, 1992, 1982, 1975 and 1971 according to economist David Rosenberg, in an interview in the Globe. Thus a long-term uptrend is intact, and the pieces are in place for a long and strong run in those sectors. The Bank Credit Analyst, a specialty research firm, has mused for awhile now that resources, commodities and emerging markets (RCEM) have the potential to be the next bubble.

Strength in resources is not without risk: China is driving the RCEM story. When China hits a bump of some kind, as it inevitably will, the RCEM story will take a bad knock, but at this point those sectors are the market leaders. Be prepared for surprising strength over the next few years – especially if we get a whiff of inflation.

Canada is rich in resources and Canadian firms are a good low-risk play on the emerging economies of the world.

Gold is strong now because of the weakness in the US dollar, which is a natural and welcome realignment of global currencies. The 'gold bugs' are predicting gold will go to the moon as the US dollar collapses. This is premature, in the opinion of the Bank Credit Analyst, an independent research firm, and an even stronger authority, the long bond market, is also showing little concern with inflation. A collapse in the US dollar would require much more inflation than is in the cards for the foreseeable future. So gold will remain firm but won't go to the moon.

In summary, bonds offer extremely low returns. Equity markets are reasonably valued and potentially choppy coming out of the crisis, so it is foolish to bank on strong returns to bail you out. Retired investors will unfortunately have little choice but to keep spending under strict control to preserve capital, while younger investors continue to focus on their accumulation program and reducing debt.

Optimism

Someone wrote recently that a pessimist always seems more erudite or informed than an optimist. Optimism is seen in our society as slightly out of touch with the facts, a little naïve, or slightly intoxicated. People have said to me, 'Oh, … so you're … optimistic …', in a slightly concerned sort of way, as if I'm a few shares shy of a board lot. If only you had all the facts and a normal intellect, they seem to infer, you too would be pessimistic.

The credit crisis has made optimists appear particularly out to lunch. Except the pessimists are wrong, almost all the time.

In the short term, a pessimist will seem correct at least once in awhile, the same way a stopped clock shows the correct time twice a day. But the pessimistic captain will never leave the wharf, so what good is that?

Lionel Tiger in his book '*Optimism*'* describes how optimism evolved with the cerebral cortex to allow humans to see both the positive and negative sides of a probabilistic or uncertain future, so the human mind could make judgments about hunting big game or planting a crop, for example. With pessimism lurking on one side of the equation, optimism evolved on the other side, so that humans would have some way of seeing both sides.

He's not talking about endorphin-laced optimism that willfully disregards danger signals. Pure or simplistic optimism can be extremely dangerous in investing, as the technology stocks demonstrated in 2001-03. Best is what I call 'skeptical optimism': longer term optimism, viewed through a prism of skepticism.

* Lionel Tiger, *Optimism – Biology of Hope*, 1979. [Not kidding about the name] Professor of Anthropology, Rutgers University, Director of Research, Harry Guggenheim Foundation.

The thing about this credit crisis, as with all crises, is that we eventually deal with it, and then we move on. It is a cycle. As with any cycle, it eventually turns. Individual investors always tend to miss the turn of the cycle, because the media is always extrapolating the most recent negative trend – driving by the rearview mirror. The media will be milking this one all the way to the next one.

As Nick Murray, longtime investment advisor and commentator said recently, confidence that the cycle will turn is not the result of blind optimism, nor is it from astute study of the details of a particular crisis. Confidence in the future comes from the *constant* study of history. History shows that the cycle eventually turns, and the recovery begins.

The Longer Term View

For the almost 30 years (1980!) since I started in this business, some Chicken Little has had some kind of impending disaster story. Yet in the face of 30 years of these impending disasters, our progress is undeniable and significant.

In the '70s, industrial pollution set the Ohio River in Cleveland on fire. The worldwide concerns were mass starvation, nuclear war with the powerful and belligerent USSR, or 'the ecology' as we called it then.

Today, a new car emits 1/100th the pollutants of the 70's engines. New hybrid crops have provided a global surplus of food. Better tires, brakes and car design have contributed to a 70% reduction in brain/spinal injuries in 35 years (that's absolute number, not per mile), according to my contact at the Ontario Neurotrauma Foundation.

From surgical techniques and tailored drug dosages, to scanning and diagnostic capabilities, our lives are incomparably healthier. These improvements are robust capabilities that form the foundations for future advancements. Nobody in his right mind would contemplate a return to life in the 1970s.

And through it all, the Canadian equity market has accumulated an 18-*fold* return since 1980[1]. The US market, even with a zero return over the last 10 years, has had a 23-fold return since 1980[1]. That means that $100 invested in the US market in 1980 would be worth $2,300 today (pre-taxes and expenses).

Hong Kong, ranked by *The Economist* as one of the world's most economically free countries, and with no natural resources other than a harbour and British legal system, has had a 35-fold return in its market since 1980[1].

These long term returns reflect the growth in the real economy, based on the things that didn't exist 30 years ago, like heart surgeons and pollution controls discussed above.

Also through it all is the relentless drumbeat of negativity from the media culture obsessed with argumentative conflict, violence, and antagonism. Bruce Mau, writing recently in The Walrus, says the media's negativity and crisis feeds feelings of 'pessimism and cynicism, which leads to apathy and paralysis' – the paralysis of helplessness made famous by Martin Seligman's classic book, *Learned Optimism*. (Martin Seligman, *Learned Optimism*, 1990).

[1] Morgan Stanley Indexes 1980 – 9/2009, Dan Richards, Globe and Mail

This onslaught of media negativity faces the true investment advisor whose job it is to see through the despondency of the current day to the facts – the facts that clearly demonstrate that the world is *not* coming to an end, our economy *will* repair its banking system, the atmosphere is *not* actually poisonous, and we are *not* all going to die of some environmental disaster (an asteroid, maybe, but the chance is low).

There are certainly problems and you don't need me to point them out. But the existence of problems does not negate the progress. And imperfection does not imply that our free-enterprise democratic system is not the best system, by far, of organizing people for progress.

On the bright side of the road, a billion people in China are making excellent progress leaving their pathetic pre-industrial agrarian Marxist society for the bright lights, the longer lifespan, the educated, skilled occupations and experiences of the 21st century. A *billion* people. Freed from the dead hand of communism, empowered by the energy of (at least) partial freedom, with a thousand years of social history, now with 177 cities of a million or more people. The potential boggles the optimistic mind. The Malthusians fret, as always, but what's the alternative? Keep a billion people at hand labor on the farm?

Of course the future will be a rough ride. How could it not be? Of course there will be crises scarier than anything we've seen before. Does the media really think there would just be one scary crisis and then easy stuff after that? The whole human story is one of adversity, effort, forging new ideas, and moving forward.

As St. Augustine said, we (mankind) are not allowed to see the future, "*for if he had prescience of his prosperity he would be careless; and understanding his adversity he would be senseless*".

And a 20-fold return isn't bad.

Does your family know what to do?

If you didn't come home from work one day, or if you were no longer able to work, would your family have enough financial resources to carry on?

If you have questions about life insurance, disability, or being able to pay the taxes on your estate, please give me a call. We are licensed and have experts in all types of life and disability insurance.

Epilogue on the Crisis

History will show that the credit crisis was caused by ill-conceived public policies that provided government guarantees for, and mandated banks to make, non-recourse, adjustable-rate subprime loans, and encouraged consumer debt through tax deductions. These policies encouraged debt-fuelled housing speculation and the subsequent defaults which, in combination with foolish debt-ratings and excessive investment leverage, were at the heart of the crisis. (see History of the Credit Crisis, www.chrishoran.ca)

And Canadians should not be smug: according to the CAAMP*, 40% of new mortgages initiated in Canada between mid-06 and mid-07 were subprime – i.e., amortizations >25 years, no money down, no principal payments for 10 years, no interest payments, and/or unemployed as much as one year in five.

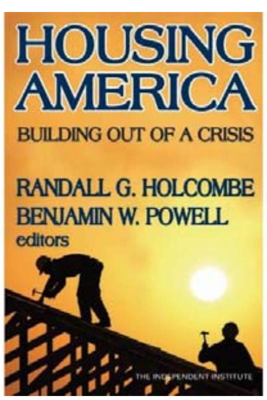
These politically popular policies were specifically to enable so-called disadvantaged Canadians to qualify for loans, because they would not qualify under traditional 'discriminatory' criteria.

Governments and regulators stood watch over every step, but were unable or unwilling to see that guarantees for unviable loans were a dumb idea. A gradually softening housing market triggered the defaults which detonated the entire picture, and very nearly took the US banking system down with it.

As we consider government initiatives to supposedly re-regulate finance, we are wise to keep in mind that it was government interference with long-established market standards that created the crisis in the first place. The crisis was not a failure of the free market, it was government distorting the free market.

* Canadian Association of Accredited Mortgage Professionals, Globe and Mail

Book Review



If you're interested in the (outrageous) role of governments in the credit crisis try "Brief History of the Credit Crisis" at www.chrishoran.ca.

For a fully detailed examination, try "Housing America Building Out of a Crisis" edited by RG Holcombe and Benjamin Powell. A collection of excellent essays with footnotes and references written to the highest standards of independent inquiry.

A must read for people interested in the role of public policy in one of the greatest destructions of wealth of all time.