December 2009

Despite numerous risks, global equity and fixed income markets are pricing in a very rosy economic scenario for 2010 and beyond. Regardless of whether or not markets suffer a near-term correction, it is clear that the lessons of the financial crisis have not been learned. Investors are once again taking on excessive risk in the search for higher yield. This is illustrated in the table below, which shows that the interest rate spread between government bonds and "junk" bonds is back to the same level as before the credit crisis.

Interest Rate Spread Between Government Bonds and "Junk" Bonds (in basis points)

Sep/ 2008	Jan/ 2009	Jan/ 2010
650	2130	610

Before the collapse of Lehman Brothers in September 2008, junk bonds yielded about 650 basis points more than government bonds. By the beginning of 2009 this spread rose to 2130 basis points as investors demanded significantly higher yield to compensate them for increased risk. Today the spread is back to where it was before the credit crisis.

Note: 1 basis point = 1/100th of 1%
Data Source: Merrill Lynch, CreditSights

There are many factors that may negatively impact markets. Consider the following:

- Consumers are deleveraging, resulting in increased saving and decreased spending
- Government stimulus spending will not continue indefinitely
- Government debt as a proportion of GDP is rising
- Interest rates will likely rise
- Corporate profit growth is being driven by cost-cutting
- Valuations for most asset classes are high

None of this implies that we are headed for a depression, or even a "double-dip" recession, but it does suggest that, as the World Bank recently stated[1], the "economic recovery is expected to be relatively weak" and "unemployment and significant spare capacity are likely to continue to characterize the economic landscape for years to come."

[1] "Global Economic Prospects 2010", January 21, 2010 World Bank

The recovery thus far has been driven by government stimulus spending and financial system support. Given the precarious state of public sector finances, these measures will be curtailed over time and the "true" state of the economy will emerge.

Over the past many years, consumer spending has driven the global economy, with American consumers accounting for about 16% of global GDP. Despite government efforts to encourage spending (such as the $8,000 first-time home buyer tax credit), U.S. consumers continue to reduce their debt in the face of weak employment and tighter lending practices. Therefore, we do not envision a quick return to the spending habits of the last decade.

Government deficits are another important factor to consider. Greece is the most glaring example of a country that is being forced to rein in spending due to high deficits. Under the Euro agreement, countries are not allowed to run annual deficits that are greater than 3% of GDP. Greece's deficit for 2009 is forecasted to be 12.7% of GDP, an unsustainable level for a country whose total debt is already 86% of GDP. Greece is in a financial crisis and the Euro has weakened. The only realistic option for Greece is to cut spending during an economic downturn, which will cause further economic pain. Deficits are at record levels in many countries – the U.S., U.K., Germany, Ireland, Russia, Spain, and Mexico, just to name a few. Even China ran a deficit of 3.3% of GDP in 2009. The table below, obtained from the International Monetary Fund, illustrates the rising burden of government debt on the global economy.

Government Debt as a % of GDP

Country	2006	2009	2010	2014
Canada	67.9	75.4	77.2	66.2
China	16.5	19.8	21.6	17.9
France	63.6	74.9	80.3	89.7
Germany	66.0	79.4	86.6	91.0
Japan	191.3	217.2	227.4	234.2
Spain	39.6	51.8	59.2	69.2
United Kingdom	43.3	62.7	72.7	87.8
United States	61.9	87.0	97.5	106.7
G-20 countries	63.1	75.7	81.6	84.6
Advanced G-20 countries	78.3	97.7	106.4	114.1
Emerging market G-20 countries	37.6	38.7	39.9	35.0

Source: IMF, World Economic Outlook, April 2009

These high levels of government borrowings will eventually result in higher taxes and reduced expenditures, contributing to a muted growth scenario. This is exactly what we experienced here in Canada in the mid-1990s, when our government belatedly dealt with its heavy debt load. It took several years of fiscal restraint before the economy returned to a normalized growth rate.

The risk of rising interest rates is yet another potential headwind. Central banks have kept short-term interest rates artificially low in order to stimulate growth. Near zero rates have, in the past, lead to asset bubbles, such as were seen in the over-heated housing markets in the U.S. and elsewhere. China recently instructed its banks to reduce lending due to a sharp rise in residential construction brought on by speculation in its own housing market.

Although central banks control short-term interest rates, long-term rates are set by the bond market. Japan has been running huge deficits for years, but its high savings rate has obviated the need for outside financing and rates have remained low. Countries that rely on external financing have less control over interest rates. Lenders are demanding higher rates for sovereign debt from countries such as Ireland, Greece, Mexico, and Spain, whose credit ratings have been downgraded. Others such as India, Portugal and Taiwan have been put on negative credit watch by the rating agencies. Even the U.K. and U.S. have been forced to support their longer term borrowings by having their central banks buy a portion of their issues. Increased debt issuance and weaker credit ratings will cause interest rates to rise regardless of the economic outlook. Increased borrowing costs will put additional stress on an already struggling economy.

In the aftermath of the financial crisis, corporate profits have rebounded (albeit from low levels) due to aggressive cost-cutting, not revenue growth. Although the rate of new layoff announcements has slowed, it is important to note that the U.S. unemployment rate declined in December only because 660,000 people had left the labour force and were therefore not counted. Had these people been included, the rate would have risen to 10.4%, nearly a post-World War II high. It seems that every corporate earnings release that we read these days emphasizes cost reduction "opportunities." Companies have learned how to squeeze more productivity out of the workforce; however, we will not see sustainable earnings growth without increased revenues.

2007 seems like a long time ago – interest rates were low, commodity prices were being fuelled by speculative buyers, investors were taking on excessive risk for minimal compensation, and valuations for everything from real estate to equities and bonds were elevated. To varying degrees, all of these factors are present today. Investors are once again chafing at the low interest rates on offer and are ignoring risk in search of yield. The mistakes of the past remind us that we will only generate good returns over time by buying high quality businesses when they are undervalued. As one of our clients in the real estate business told us recently -you make your money when you buy a property, not when you sell it - a low purchase price is the key. The same is true in the investment world. We have refrained from buying equities since we opened in August because valuations appear rather expensive given the risks that exist.

We wish you all the best for a peaceful and healthy 2010.

Sincerely,

Lorne Steinberg