

OVERVIEW

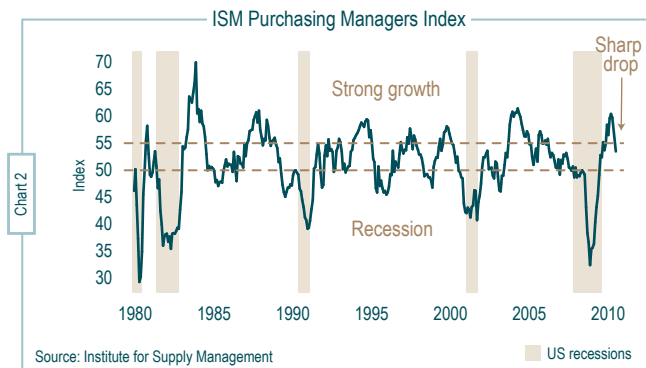
Escape velocity is an astrophysics term that describes the speed needed to break free from a gravitational field. From a financial perspective, the concept of escape velocity could also be used to describe the developed world's struggle to break free from the crushing influence of exorbitant debt loads into an environment of sustainable economic growth. While the current poster child for this problem is Greece, the real problem rests with the largest economy in the world, the US. Over the last three decades, American debt as a percentage of GDP more than doubled from 140% to over 290% before hitting a "tipping point" (see Chart 1). The tipping point came about because of two huge gravitational forces – asset values that were propped up by a mountain of debt started to fall and the serviceability of the debt itself became increasingly problematic.



To right this situation, debt as a percent of GDP in the US needs to contract by 25%. This is going to be a major drag on economic growth because the economic tailwind that was created through massive debt formation lifted GDP by an additional 1% per year over the last few decades. This is now turning into a headwind. De-leveraging will be a daunting task because the problems in the private sector, in terms of too much debt, have now spilled over into the public sector where governments have been fighting a pitched battle through massive deficit spending to try to stave off a deflationary collapse of the economic system. OECD nations have seen government debt to GDP balloon by over 20% to over 93% in the last three years alone. This compares to a 10% increase from 63% to 73% over the previous 15 years. Anytime government debt to GDP exceeds 90%, servicing

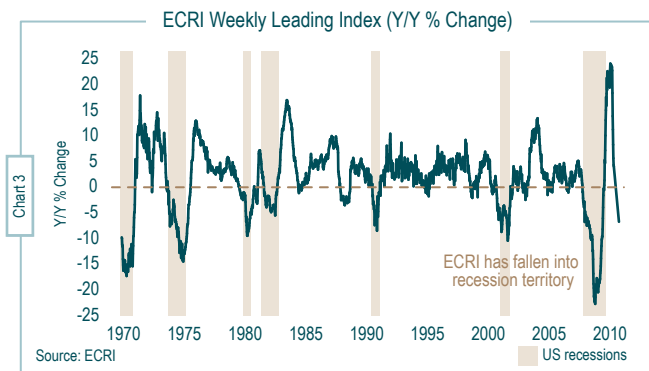
costs start to grow exponentially eating up an increasing amount of government revenue that otherwise could have been spent more judiciously on essential programs.

Governments have taken the right action by pumping money into the system to stabilize the economy and kick-start growth in the private sector. However, at some point there has to be a hand-off to the private sector which needs to stand on its own without massive government support. We appear to have reached that point because governments can no longer continue to rack up debt at current rates. The question is whether there is currently enough forward economic momentum (velocity) in place to lift growth to a sufficiently high level so that the economy can escape the grip of deflation. The picture here is clearly mixed. For the past year the majority of leading economic indicators, such as the LEI (Leading Economic Index), the ISM Manufacturing Index and the OECD Leading Index, have been pointing to a "V" shaped recovery, which would have brought about rising employment and incomes. However, these indicators have recently rolled over. While this was expected, they are dropping at a much faster rate than is the norm and certainly faster than consensus forecasts predicted. Whether they stabilize or not is open to debate, but it is clear that at a minimum they are signalling that the maximum rate of positive change is behind us (see Chart 2). Fortunately, for the time being they are still pointing to further economic expansion even though it will be much weaker than originally anticipated.



At the moment we are paying special attention to the ECRI Leading Index which continues to fall and is currently signalling that the

US economy is about to relapse into recession (see Chart 3). This indicator's track record is pretty good, but fortunately not perfect. It is weighted to market factors such as commodity, equity and bond prices and thus prone to the odd false signal, such as the recessionary calls it made in 1987 and 1998. On a more positive note, there are still some encouraging signs for future growth: (1) Asia and Latin America continue to show signs of strength, and domestic demand in those economies remains robust which is a positive for exports, (2) credit remains available and at a reasonable price, (3) growth in incomes while not robust is steady, (4) corporations are in good shape financially to increase capital spending, (5) energy prices remain well behaved and (6) mortgage rates have been declining as of late.



The deflationary forces that are lingering just below the surface in the US are already popping up in Europe. The current crises hitting the countries in the periphery of the European Union (EU) are showing some disturbingly similar patterns to the two most recent credit crises (the Asian crisis of 1997–1998 and the US crisis of 2007–2009). A credit crisis tends to start slowly and takes some time to build the mass required for a full-blown event. This is because there is usually a trigger that starts the whole process and at the time it is largely dismissed as being an isolated event and sufficiently small so as to be of no real consequence to financial markets. For example, the Asian crisis started when Thailand devalued the baht in the summer of 1997, which led to competitive devaluations throughout the developing world late in the year and culminated with the collapse of Long-Term Capital Management in the fall of 1998. The recent US credit crisis started in 2007 when the sub-prime mortgage market started to go sideways culminating in the collapse in Lehman Brothers in the fall of 2008 and the ensuing global melt down of equity markets in the spring of 2009. Today, the once seemingly isolated sovereign debt event in Greece is starting to spread to other Mediterranean countries and in turn the European banks. Already the interbank funding markets in Europe have started drying up, and banks have had to rely heavily on the European Central Bank for short-term financing. This

has the potential to push credit spreads wider and reduce liquidity on a global basis, precipitating a further flight to safety.

It is almost impossible to predict how events will unfold as not only is the depth of the problem not clear, but neither are the future responses that will be forthcoming from the regulatory authorities as the crisis plays out. However, we expect that the European authorities will be forced to monetize a large quantity of impaired sovereign credit assets, which will precipitate further declines in the value of the euro, which in turn is a deflationary event for the rest of the world. This is coming at a time when the Europeans are embracing fiscal restraint and at a time when final demand is weakening and consumer sentiment is poor – a potential policy mistake.

Policymakers face a number of dilemmas as they try to navigate through these volatile and troubling times. Everyone knows it is imperative that at some point fiscal largesse has to be reined in because to continue down the current path invites an escalation in the sovereign debt crisis. However, too early an exit will abort the delicate recovery. Monetary policy must stay expansionary, especially in light of the fact that governments are withdrawing stimulus, but too loose a policy will sow the seeds of the next asset bubble. Finally, there is a need for greater financial regulation, but not so much that it discourages the banking industry from extending credit, which would keep the economy from moving forward. It is a very delicate balancing act and there is plenty of room for major policy errors, which highlights the very real need for the economy to reach escape velocity. It also highlights that there is a high degree of fat tail risk in the current environment.

CAPITAL MARKETS

Ten-year US Treasury yields have fallen through 3% (see chart 4) with Canadian 10-year government bonds close behind. Interest rates have been held in check by a Fed Funds rate near zero, low inflation, weak credit demand and increased risk aversion on the part of investors.



Credit spreads have been widening as of late and European sovereign spreads for Club Med countries have blown out – thankfully not to anywhere near the extent that they did during the Lehman Brothers banking/credit crisis. On the other hand, credit default swaps (CDS) on Greek sovereign debt have reached new highs despite the EU and IMF rescue packages. But more troubling is the fact that there are mounting problems in the European banking system as primary and secondary credit markets are starting to become paralyzed and liquidity is scarce. European bank shares have been slumping, which may foretell there are more problems to come.

Equity markets have also come under pressure with the MSCI World Index declining 8.5% in the second quarter, which is approximately where year-to-date returns stand now. This is not totally surprising because stock markets typically struggle during the second year of a recovery because of the uncertainty as to its sustainability. Looking back over the last few recessions and cyclical stock market bottoms, we can see that in 1976, 1984 and 2002 markets basically went sideways –1992 was the exception. The second year of a recovery also tends to be a time of heightened price volatility. This cycle seems to be no different. After a short-term retreat from recent highs, the VIX has moved up again, signalling waning confidence on the part of investors (see chart 5).



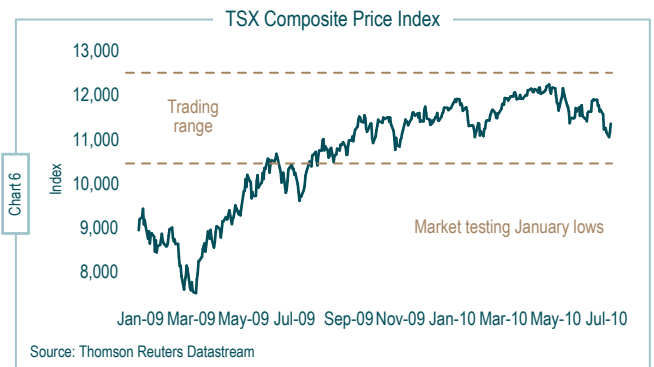
With the recent stock market sell-off, valuation levels look increasingly attractive. Current P/E multiples appear to be compelling at 16x trailing and 14x future earnings. However, it should be noted that whenever the 10-year US treasury yield falls below 3%, P/Es come under downward pressure, declining to 12x on trailing earnings, and when inflation drops below 1% they fall to 13.5x on future earnings (see table 1). In addition, there also appears to be a strong relationship between the price of gold and P/E multiples. They tend to be inversely correlated – thus a persistent uptrend in bullion prices will be a drag on P/Es as well. These are important factors to keep in mind because even with the exceptional strength we have seen in earnings growth, a recalibration in market multiples will always overwhelm any change in corporate profits.

Price/Earnings Multiples

Trailing Earnings Multiples (S&P) Relative to Bond Rates		Forward Multiples (S&P) Relative to Inflation Rates	
10-Yr Yield	Average P/E Multiple	Inflation Rate	Average P/E Multiple
<3%	11.9x	<1%	11.8x
3-4%	16.3	0-1%	13.5
4-7%	17.7	1-2%	17.7
7-8%	13.5	2-4%	15.8
8-9%	13.1	4-6%	14.1
9-10%	10.7	6-7%	11.3
>11%	9.3	7-10%	9.4
		>10%	8.0

PORTFOLIO STRATEGY

Clearly risks have risen because of the potential for a double-dip recession and/or further contagion from the European sovereign debt crisis. But the odds of this occurring are probably less than 25%, so moving to a large overweight in fixed income is not warranted at this time. However, reduced exposure to equities is prudent given the increased risks of a fat tail outcome (<25%), but only to benchmark weights. It is important to keep in mind that while investors are currently demanding that they be paid for taking on systematic risk, this is now priced into the markets with P/E multiples relative to inflation at extremely low levels and earnings yields very high relative to interest rates. Should the perception and/or actual systematic risks subside then equities will enjoy above average returns as investors recalibrate risk premiums. As such, we continue to expect equity markets to trade in a wide range of 960 to 1250 on the S&P 500 (currently 1050) and 10,500 to 12,500 on the S&P/TSX (currently 11,350 – see Chart 6) not unlike the trading pattern back in the 1970s. We do not expect the market to fall below the bottom end of these trading ranges because, as noted above, the European sovereign debt crisis has been kicked down the road and a double-dip recession is not a high probability.



On the other hand, fixed income risk premiums are very low, and should perceptions change and/or actual systematic risks subside, then yields will back-up as bond prices fall. As such, our strategy for both asset classes (bonds and stocks) will remain tactical with a defensive bias until there is more clarity that we have achieved escape velocity.