



## McLean Budden Perspective

Fiscal Follies, Common Currencies and Inflation Frustration:  
Macro and Investment Themes For the Rest of 2011

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# Fiscal Follies, Common Currencies and Inflation Frustration:

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We believe there are three main factors behind the pullback in risky assets and rally in bond yields over the past few months:

1. A slowdown in global economic growth and growth expectations
2. Tightening in emerging markets/China due to rising inflation – which is in turn impacting expectations for future growth
3. Europe's sovereign debt crisis

Before examining each of these factors, which are all somewhat inter-connected, we would note that we believe that most of weakness appears to be priced into the markets. Therefore any near-term positive economic surprises would be constructive for global stock markets. The major macro risks appear to be policy related – i.e. policy errors in Europe or in the U.S. regarding the budget outlook/debt ceiling – which could lead to a sharp market decline with negative economic consequences.

### Slowdown in growth/growth expectations – part cyclical, part structural

Optimism from earlier this year, regarding economic growth, has given way to pessimism and growth expectations have been cut. This is partly due to the jump in oil prices that occurred earlier this year as well as the impact on the global supply chain from Japan's earthquake. Unless oil prices continue to drop sharply – back to the mid-\$80s for WTI Crude – this will remain a drag on growth. On the other hand, the impact of Japan on the supply chain should be temporary. Auto production is expected to bounce back in Q3, and we expect to see an improvement in the major U.S. and global manufacturing surveys in the next month or two. Somewhat discouragingly, the June and early July readings did not meet these expectations. Also concerning is the recent setback in U.S. employment. After steady job gains earlier this year, May and June have seen a renewed uptick in the unemployment rate and dismal job creation (though still positive). At the moment, global leading indicators point to slow but still positive growth.

If surveys don't recover and U.S. employment continues to falter, then a deeper slowdown is likely. The U.S. Federal Reserve (Fed) has recently completed 'QE2' and, in our view, the hurdle for further easing is high. Fed Chairman Ben Bernanke has mentioned the possibility of further monetary easing if the recovery falters. We do not believe such easing is imminent, nor that it will be overly effective as the post-crisis economy is exhibiting characteristics of a liquidity trap. Furthermore, housing prices in the U.S. continue to decline. Fiscal policy is tightening as austerity measures are implemented across the globe.

Another feature of the recent downshift in global growth — that has again surprised investors — is the stop and start nature of the recovery. Whenever there are periods of strength in activity, over-enthusiasm takes hold and investors begin to discount a 'normal' recovery. We continue to believe that this is not a normal recovery, particularly in the developed economies. This is the legacy of a post-credit crisis world, where balance sheets de-lever, consumers and businesses are cautious, policy efforts inevitably peter out and inflation pressures remain low. In addition, the private sector's credit cycle — so very important in supporting strong economic growth — does not take hold. As we've long stated – it was not a normal recession, so how could it be a normal recovery?

### Tightening in emerging markets/China

Emerging markets came out of the crisis with their economies on fire. They didn't have a banking crisis, their economies were not over-leveraged, yet significant stimulus was delivered and output responded. Two years later, their economies are operating above capacity, wages are rising and inflation is being driven by excess demand and higher global food and energy prices. These conditions are a function of speculation and U.S. monetary policy to be sure but also due to emerging market demand as well as the excess money and credit which was created in 2008 and 2009.

In response, emerging economies have tightened monetary policy, rationed credit and, in some cases, imposed capital/currency controls. In China, the banking system (and so called 'shadow' banking system) is leveraged and vulnerable to a rise in bad loans. India has tightened aggressively as well. With growth in emerging markets now slowing due to the lagged impact of tightening and cooling global growth, inflation pressures are likely to peak soon but should remain high. A soft landing for the economy is the base case scenario, but risks need to be monitored in the next few months if inflation remains stubbornly high and does not crest. If a soft landing materializes, the current correction in commodity prices will reverse soon. A hard landing will likely imply a commodity bear market.

Longer-term, the emerging markets remain a great growth story, but not without macro risk. Take China as an example. Growth has slowed sharply in the past few months and will likely slow further as tightening continues. The risk over the next few years is a deflationary shock should their housing bubble pop and their investment boom — currently 50% of GDP — comes to an end. Even at the peak in 1989/90, Japan's investment share of GDP was around 35%. The weakness in China's stock market is a sign that growth is not set to pick up soon. On the positive

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side, if inflation does moderate and a hard landing becomes the base case, China has ample room for monetary and fiscal stimulus. China will undergo a leadership change in 2012, so it is unlikely that the authorities will want the economy to be overly weak during the transition. However, much will depend on the inflation outlook.

### Europe's sovereign debt crisis

Europe's sovereign debt crisis took an ominous turn in the past few weeks. Market turmoil spread to Italy and there was a general lack of faith that the recently completed 'stress tests' of European banks adequately accounted properly for all exposures. The message being sent to European policymakers—deal not only with Greece but all high-debt and vulnerable countries. Italian 10-year government bond yields briefly touched 6% and Spanish 10-year yields hit 6.3%, disturbingly close to the 6.5%-7% 'line in the sand' where the debt and growth dynamics take yet another turn for the worse. By way of comparison, Greek 10-year government bond yields recently peaked near 18% and 2-year yields reached 37%! A riot point had arrived, since the EFSF bailout fund was not large enough to support Spain and Italian in addition to its other commitments.

The July 21st Emergency EU Summit was encouraging in that the EU has belatedly admitted that Greece requires permanent debt relief. The details are still fluid, but it appears as though Greece will not only get its second bailout of 110 billion euros but see interest rate terms modified and maturities extended (this will apply to Ireland and Portugal as well). These measures will come alongside a re-capitalization of Greek banks. What remains unclear is whether the rating agencies will treat this as a default, whether the European Central Bank will cave and continue to accept Greek government bonds as collateral and what the private sector will bear in terms of losses. What has not been finalized, but appears likely, is that the size of the EFSF will be raised with the ability to buy peripheral debt on the secondary market. These developments take pressure off of Italy and Spain.

While a good first step, this is not a permanent solution. Besides coming to an agreement on ECB collateral and a more robust bailout fund, we continue to believe that closer fiscal ties are inevitable, with a pan-European 'bond' likely to emerge. If the monetary union is to survive, closer fiscal ties seem inevitable.

### How are these three factors inter-connected?

We believe that the three factors listed above are a by-product of the aftermath of the 2007-2009 banking crisis/recession and the Fed's easy money policy response. Of course, the Fed's policies was one of the many contributors of said financial crisis, but don't get us started on that one! For example:

- > The response to the 2007-2009 banking crisis and subsequent weak recovery was repeated stimulus measures –fiscal and monetary policy. Now, those fiscal measures and resulting legacy of debt have become a crisis in its own right. This takes a page right out of the excellent research by Reinhart & Rogoff who have shown that historically, banking crises often become sovereign debt crises.
- > Strong growth in emerging markets, leads to upward pressure on commodity prices and therefore inflation. This hurts real wages in the developed world, where unemployment remains high. With growth slow and unemployment high, central banks (i.e. the Fed) need to keep the system flooded with liquidity and cheap money, weakening the U.S. dollar and putting further upward pressure on commodity prices which further hurts real wages. Talk about QE2 backfiring!

### Concluding thoughts and market implications

The uninspiring economic backdrop means lots of fits and starts for the recovery and volatility in markets and the economic data. Business cycles may become shorter again, as policy can't respond as it could in the past because both monetary and fiscal levers in the developed world have been pushed to their limits. In a sense, the sustainability and legitimacy of Western governments is being put to the test. An ageing population needs higher interest rates and their retirement/health care entitlements. Younger voters assume there will be some default on these entitlements or taxes will go up to keep them intact. All of this is being questioned by voters in the West. In the U.S., the political system is in a virtually permanent state of gridlock and voters don't trust elected officials. This is clearly on vivid display in the recent negotiations over lifting the debt ceiling. In our view, savings rates will likely remain high, which means less spending and growth.

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Governments face the delicate balancing act of some cuts today or more cuts tomorrow, but need to appear as if they will continue to do 'whatever it takes' in times of crisis to maintain their legitimacy. Decades of piling up debt upon debt and never letting excesses fully purge has set up the ultimate moral hazard – voters want both a balanced budget and bailouts. They want entitlements and low taxes and they want cheap borrowing rates but high rates for savings. Western governments can see the future and it looks like Greece.

Our investment approach in this environment remains focused on high-quality companies with strong balance sheets and who have pricing power in a low inflation world with deflation risk. In our opinion, large cap equities should do well. We use the same approach in bonds — a focus on high-quality corporate debt and active bond management in a low inflation/low rate world.

In the near-term, we think a lot of bad news is already priced in. Assuming no recession and no 'Lehman II', in the form of a major policy error out of the Eurozone, it looks like a lot of pessimism exists in economic expectations and investor sentiment. The upside in equities in the near-term may be limited, but so is the downside. This year's uninspiring stock market performance vs. 2010 and 2009 is consistent with the 3rd year of a bull market – returns lower but still positive. Valuations for the major indices are approaching last year's trough levels, even accounting for some further cuts to earnings estimates. It seems that markets are at levels where positive surprises may begin sooner than later.

In terms of the bond market, our out-of-consensus earlier year position that yields would decline has worked well and we have taken profits on our overweight position and our asset mix is now targeting a neutral bond exposure. Our bond team, however, has re-initiated a modestly long duration position because the global economy is expected to remain soft, inflation tame and bond valuations are not overvalued according to our proprietary models.

Within asset mix, we believe stocks will outperform bonds and remain moderately overweight. Even if earnings growth slows toward 5%, adding in a 2% dividend yield suggests a 7% total return, which is significantly better than the roughly 3% yield in the Canadian fixed-income universe.

What would turn us more bullish? In the near and medium-term, we would be highly encouraged by an agreement out of the U.S. that gets a handle on the long-term fiscal outlook. Not only would this avoid a downgrade to the AAA sovereign credit rating, but we think this would be highly positive for P/E multiples, investor confidence and likely reduce a major source of uncertainty in the corporate sector regarding capital spending and hiring.

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