

“He Who Goes Borrowing, Goes Sorrowing”

Ben Franklin

If there is one piece of data that will embody 2009, it is this - U.S. \$1.4 Trillion

That is the official U.S. budget deficit for the fiscal year 2009. The deficit is more than triple last year's record high, 9.9% of the U.S. annual GDP, the highest since 1945. In short, the U.S. government is spending as if a war of superpowers were choking the world economy... though hardly a shot has been fired.

Some other relevant expense statistics:

- Social Security: \$659 billion, up 8.6%
- Medicare: \$428 billion, up 9.8%
- Medicaid: \$251 billion, up 24%
- Defence Spending: \$636 billion, up 7%

The problem with all these new spending programmes is that the U.S. does not have the money to pay for them. Treasury Secretary Geithner has asked Congress to raise the \$12.1 trillion ceiling again before the limit is hit this fall (we are currently at \$11.93 trillion. Over the past six and one-half years, the Treasury Secretary has asked Congress to raise the ceiling 8 times. The ceiling has been raised four times over the past two years. Not much of a “ceiling” is it? The Obama administration forecasts the full-year deficit to be \$1.58 trillion, 245% higher than last year's record deficit of \$458 billion.

The consumer debt to net worth ratio steadily rose in the past eight years peaking at about 28% in 2008. These high debt levels, when combined with a collapse in the housing and stock markets in 2008, created a severe squeeze on consumers around the world, leading to lower spending and higher savings rates.

United States

- Due to the length of this recession (the longest since the 1930's) the requests for federal handouts just keep on coming
- More than five million people have been out of work for longer than six months and are still looking for work
- In many hard-hit states, unemployment benefits have been increased to 79 weeks
- The House of Representatives in Congress recently passed a bill increasing the maximum to 92 weeks. It has not yet passed the Senate
- Continued job losses and tighter credit are crimping the U.S. consumers ability to spend
- Job losses were larger than expected in September, while August and July data were revised downwards
- The decline in payrolls was across all sectors with the majority coming from the service producing sector

- As of July, there were nearly 36 million Americans receiving food stamps (more than one out of every nine citizens), an increase of 6.8 million (23%) from a year ago
- The total monthly food stamp programme expenditures in July 2009 were a massive 62% higher than a year ago. The programme cost \$35 billion in fiscal year 2008 and is expected to increase to \$57.4 billion in 2009
- There are still an estimated 5-6 million homes that will enter foreclosure in the next few years
- A crisis could unfold down the road if the government is unable to regain control over the budget
- The U.S. is doing absolutely nothing to defend the dollar. In this way they will try to minimize the importance of the debt with a cheaper devalued dollar
- Retailers reported an average 3% drop in same-store sales for August
- Industry giant Wal-Mart no longer reports monthly numbers
- Home prices in 20 major U.S. metropolitan areas, declined by 13.34% on a year over year basis
- Low and falling inflation and lingering concerns about the strength of the economic recovery argue against an early tightening in monetary policy
- Domestic demand rebounded as imports increased 8.3% in July compared to a 1.2% decline in June
- Recent signs of stabilization in the housing market in the U.S. is of great importance to the economy as it will act to improve consumer confidence and restore profitability to the banking system
- As housing starts improve, construction activity will accelerate, creating new jobs and reducing the current high level of manufacture and labour slack in the economy

Canada

- Canada is highly dependent on the U.S. with 70% of our trade directed to the U.S.
- Canada's exports to the U.S. declined 41% to \$1.9 billion in July from \$3.2 billion in June
- As Canada's trade deficit grows and retail sales decline, Canada's economy appears to have stalled with unchanged month over month results in GDP
- With the lower U.S. dollar, Canadian manufacturers are at risk
- Canada's energy producers will benefit from rising oil prices
- Rising metal prices help Canadian mining companies
- The Canadian Banking system remains strong
- The Canadian housing market has seen prices recover as affordability due to low financing costs remains at high levels
- For the time being in Canada, economic activity is not getting worse

Asia

In contrast to the \$154 billion of U.S. Treasuries purchased by the Chinese over the last four months of last year, the past four months of data from the U.S. Treasury Department for this year (through July 2009) show that China has only purchased \$33.6 billion and over the past two months have actually reduced their holdings of U.S. Treasuries by \$1 billion to \$800.5 billion. The second largest holders of U.S. Treasury debt are the Japanese at \$725 billion. They have purchased nearly \$100 billion of Treasuries in the first seven months of this year. However, the recent election of a new DPJ government, after 53 years of LDP rule, may cause a shift in foreign reserve holdings there as well. The DJP government has threatened to no longer buy U.S. government bonds denominated in U.S. dollars. They would only buy U.S. "samurai bonds" denominated in yen.

- China will be competing increasingly with the U.S. to make wanted items
- First simple items like fans and toys and refrigerators; then autos; now its airplanes and soon it will be complex technical items plus everything in the medical field
- China wants to replace the U.S. as the leader in the world economy
- China's leaders have one main goal - to keep hundreds of millions of Chinese employed; happy workers do not want to revolt and overthrow the government
- Asia's role in the market for super high end luxury goods is mushrooming, reflecting the underlying shift in consumer spending power that has been creeping along for years
- Wealth and purchasing power is moving from the developing nations to Asia.
- While the U.S. spends trillions of dollars in an effort to boost consumer spending, China spent millions on building competitive industries like autos and airplanes manufacturing
- It is not going to result in a happy ending for the U.S. as their standard of living heads down and down while China's heads higher

What this means for the markets

- The Federal Reserve probably will not raise rates any time soon
- Stocks continue to drift higher, and have nearly broken out of their pre-Lehman trend
- The equity rally will soon move into a more challenging phase as earnings take over from expanding multiples as the key driver
- A sharp decline from current levels is unlikely, but a near term consolidation is probable
- With earnings likely to grow at an underlying pace of around 5% a year, stocks should continue to outperform bonds and cash
- Treasury yields will remain anchored by lower inflation and low short term interest rates during the coming year
- The U.S. dollar will drift lower for the foreseeable future.
- If the U.S. keeps printing money to buy bonds, it will lead eventually to inflation and higher interest rates
- Very little money has been put into U.S. equity mutual funds with investors pulling over \$9 billion out of mutual funds in the past 6 weeks

- Since March over 90% of investor cash has gone into bonds with the balance supporting the stock market recovery
- Strategies and companies that can benefit from borrowing short to lend long will continue to thrive in this environment
- Investors will be attracted to high yield assets as well as growth companies that can thrive in a relatively slow growing economy
- Gold has climbed above 1000 and appears to be heading for 1100. Silver, only eight dollars an ounce last year, is not above \$17 an ounce

Things to consider

- Reports that China, France, Japan, Russia and Gulf states were working to replace the U.S.\$ as the currency for commodity sales
- What matters is where OPEC oil producers and rising export powers choose to invest their surpluses
- If they cease to rotate their wealth into U.S. treasuries, mortgage bonds, and other U.S. assets the dollar must weaken over time
- The world is massively overweight the U.S. dollar
- As people invest a little here and little there in other currencies or gold, it slowly erodes the dollar
- This trend is not likely to reverse for many years, but contrary to the prevailing wisdom, higher savings rates in the U.S. will be a powerful and positive tonic with respect to stabilizing the global economy, and creating sustainable, albeit, slower, long term growth for investors

On the subject of economic activity, though it continues to be fitful, Jim Grant, in his latest issue of Grant's Interest Rate Observer, makes the case, based on his own reasoning and research from the Economic Cycle Research Institute, that whatever bounce the economy is experiencing and will experience in the short term might be bigger than people think. "That's not to say that any economic bounce will evolve into a "normal" job-creating, self-reinforcing recovery (which I believe it won't). But at this point, it's not important to have an opinion about that. The important thing is to know that for the time being, economic activity is not getting worse. However, given the mindset of central bankers and finance ministers the world over, whatever the rate of improvement is, it won't be fast enough (especially given high rates of unemployment) and they will continue to create extra stimulus, ergo my desire to try to capitalize on money printing in any way that I can. That is also why I believe that the high-probability outcome for the U.S.A. (though maybe not this quarter or the next) will be stagflation."

Economist A.C. Pigou great quote, **"The era of optimism dies in the crises, but in dying it gives birth to an era of pessimism. This new era is born, not an infant but a giant."**

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