

**TO: CLIENTS & FRIENDS**  
**FROM: TWIN FOCUS CAPITAL PARTNERS, LLC**  
**RE: QUARTERLY COMMENTARY, OCTOBER 2009**

***“Capitalism needs to function like a game of tug-of-war.  
Two opposing sides need to continually struggle for dominance,  
but at no time can either side be permitted to walk away with the rope.”***

**- Pete Holiday**

## **Executive Summary**

The global economy now appears to be turning the recovery corner after coordinated efforts of central banks and treasuries to provide Keynesian and monetary stimulus. What remains to be seen is how sustainable this recovery is once these stimulus programs begin to be unwind. We remain constructive on a short term basis and optimistic over prospects of a recovery. However, we believe that 2010 will face many headwinds.

The past several months have seen many converts to the cyclical sustainable recovery view and as such market sentiment has become considerably more bullish. However, from our perspective, recent data releases on balance have failed to reinforce our longstanding view that the recovery will not be self-sustaining. In allocating new capital, we continue to bide our time, waiting patiently for the right time to express serious conviction in risk allocations.

Private sector savings has risen from a negative print to over 5.0%, and will rise further in the period ahead. The result will be significantly slower growth in US GDP over the next several years as the US consumer entrenches and the only other GDP component likely to pick up the slack is the US government.

The public sector will strong-arm the private sector for some time while central banks and governments find it difficult to coordinate and implement effective exit strategies. The Fed and other Central Banks will have to replace the former shadow banking system as a means of financial intermediation.

There remains serious risk of “policy error” exists that could fatally threaten the recovery in 2010 as the developed world attempts to unwind extraordinary monetary policy stimulus. The scope of this serious policy error in the timing and execution of the exit is considerable, particularly in those countries that have engaged in large scale asset purchases (quantitative easing) financed by the creation of bank reserves.

The global economic landscape has changed fundamentally for some time to come. Emerging countries which were in the midst of severe economic crisis just one decade ago are now in a position to demand more say in our international institutions as the developed world is becoming more dependent on them.

We believe that the idea of home prices stabilizing because of a couple of months of relief from the Case-Shiller index may be very premature and ultimately disappointing. Considering the rising unemployment rate, it seems very hard to believe that we have seen the peak in delinquency and default rates.

Sustainable growth will require rebalancing demand across countries and regions. This process which we now pen, the “New GI Bill”, will be needed to eliminate the vast global imbalances that were built up from the period of 2000 to 2007. This will require a 180° change in policy and attitude in those countries.

Because the aging developed country big-spenders are tapped out, we need a strategy that will bring both spenders and savers into economic equilibrium. This will require tremendous political will as well as global institutional mechanisms that do not currently exist, evidenced by the lack of concrete directives at the G20 meeting or proposals by the IMF.

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The banks are still sitting on over \$1 trillion in cash assets, and they are putting the proceeds to work in the government bond market, snapping up over \$50 billion of Treasuries and Agencies in September alone. The banks are basically lending the Fed's reserve creation right back to Uncle Sam to earn the spread that is artificially created by the government at the expense of taxpayers. Conversely, the major banks are financing the deficit and earning a nice risk-free return in return to help them earn their way back into solvency.

The weakening USD has made US goods and services more competitive. With US consumption in stagnation, exports can be an effective way to jump-start the economy but betting on a US recovery on the domestic consumption patterns of foreign sovereign states is a new concept and not without risk given our previous discussion on the need for global rebalancing and the fact that net exports is not a very significant percentage of US GDP, at least for the time being.

The S&P 500 is up over 55% from the March lows. Never before have we seen the stock market rise so much off a low over such a short time period, and usually by this time, the economy has already created over one million new jobs. We believe that US equity markets are overvalued vs the fundamentals, by most metrics.

The bond market is telling us that we still live in a deflationary world, yet the equity market is at this juncture pricing in over \$80 of operating earnings, which would be double from the current four-quarter pace.

We believe that the European Index has more P/E-multiple expansion to grow and this will be the central reason why this index should outperform the SPX going forward. While Europe faces multiple problems that will require political will and major structural change within the Eurozone, we believe that there are opportunities for these developed markets to outperform the US.

Emerging markets should matter a great deal for all investors, now and for the rest of our investing lives. Investors focusing on benchmarks will miss this opportunity. The end of the term "emerging markets" is here. Investors that don't catch on to this reality risk being left behind.

Although the global economic crisis is far from over, China has been able to engineer resumption to growth patterns in May of 2009 with very vigorous responses through a unique mixture of Keynesian policies and governments planning.

Over the longer term, as we have previously emphasized, the secular bull market in commodities is a supply story due to decades of suboptimal investment. However, in the near term, we believe that commodities have become overly anticipatory. Therefore, if we see the global recovery showing signs of sputtering, we would expect sharp corrections in the commodity space given the lofty good news already built into the prices in the shorter term.

We focus on drivers of return, rather than solely trying to forecast what each asset class may deliver. We additionally believe that a well thought out and globally diversified basket of investments should provide exposure to both cyclical and secular themes.

Over the next 5 to 10 years, tactical or active asset allocation will be essential to successfully navigating risk markets as investors are forced to consider both large tectonic macroeconomic shifts in addition to specific micro elements. In the current market environment we continue to remain nimble with moderate allocations to risk assets and overweights to areas where we feel there is a larger probability of exploiting the structural themes in global capital markets.

In the near term, we expect to see benign global inflation as well as benign to moderate inflation in the US. Despite the massive quantities of paper currency printed by world central banks over the past twelve months, we do not yet see this causing hyper-inflationary conditions witnessed during the late 1970s.

We remain cautious in the short term over many of our conviction plays such as emerging markets and commodities because markets have moved up very quickly, anticipating and overly discounting the good news to come. We therefore would welcome a healthy pull-back that could be over 20% to 25% in many cases, allowing us to enter at more opportunistic price points.

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We advise clients on such issues as business & strategic planning, asset allocation, portfolio construction, investment search & selection and provide a customized client-specific ongoing due diligence & review process. We seek to uncover opportunities that help our clients meet their objectives by exploring non-traditional paths through exhaustive research and a disciplined approach to risk management. We invest across all asset classes including Absolute Return and Hedge Fund strategies, as well as direct positions in Real Estate, Venture Capital and Private Equity.

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## **Introduction**

The focus of economic policy from a macroeconomic perspective has been on tackling the immediate problems of major financial institutions, stabilizing the world economies and trying to restart economic growth. The current economic downturn was not only severe and prolonged but also quite widespread – essentially all industrialized and many of the emerging markets had been affected. This market turbulence and deteriorating growth prospects prompted aggressive G7 monetary loosening. Indeed, all of the major central banks cut administered interest rates to unusually accommodative levels. The rescue initiatives were unprecedented in scale and scope. As governments were borrowing to adopt expansionary fiscal programs, monetary authorities effectively were converting private debt to public debt and ran fiscal deficits never before experienced during peacetime periods. These were arguably necessary actions given the world economy fell off a cliff. At the beginning of 2009, the annualized drop in a quarterly moving average of world industrial output reached 25 per cent while the fall in world trade was even more extreme.<sup>1</sup> Most countries saw a decline in both imports and exports of about 30% from September 2008 to January 2009.

***Is this stimulus working?*** Since our last quarterly commentary, data from governments around the world continue to indicate the global recession is slowly unwinding. Although financial shockwaves are still being felt in many sectors and regions throughout the world, G7 economies have seemingly stabilized during this quarter, with positive growth resuming or expected to resume in the second half of 2009. In fact, the IMF is now predicting that the world economic output will rise by 3.1% in 2010 after contracting -1.1% in 2009.<sup>2</sup> In light of this apparent stabilization, economists are proclaiming the beginning of economic recoveries and discussing the need for exit strategies from these stimulus programs. They foresee renormalization of policy rates will begin the second half of 2010 with the risks to global growth now appearing balanced. Economies have stabilized, and "green shoots" of recovery have sprouted.

Using a long term perspective, we believe the prospects for a sustained global recovery are far from certain. We believe the causes of the current economic and financial crises were sown by economic policies of the major developed countries that fostered growth of global imbalances during the 2000s at unprecedented levels. Large and persistent imbalances drive larger capital flows which can destabilize the global economy.

Though some of the stimulus policies will facilitate global imbalance adjustments, others will persist and new imbalances will be created by policymakers' attempts to stimulate economies and markets. Actions in many countries appear very likely to add to imbalances over time, and the lack of needed policy actions, especially structural reforms in some countries will delay adjustment as well. Upon close analysis, many of the global economies are not making the necessary structural adjustments to ensure continued and stable global economic growth. That said, partial adjustment in imbalances is taking place in the United States. Private sector savings has risen from a negative print to over 5.0%, and will rise further in the period ahead. The result will be significantly slower growth in US GDP over the next several years as the US consumer entrenches and the only other GDP component likely to pick up the slack is the US government. Additionally, with US consumers who represent approximately 20% of global output, decreasing their consumption patterns, the global economy can no longer rely on the US consumer for demand, leaving the expected rise of the emerging market consumer - specifically the Chinese - a necessary condition for a stronger world economy.

*Unfortunately, the slack in world demand left by the softening U.S. growth is not likely to be picked up by any of the other major global economies in the near term. All of them have been, and appear likely to continue to be, heavily dependent on exports to drive growth and create*

<sup>1</sup> "Finding a route to recovery and reform gets tough now", *Financial Times*, Martin Wolf, October 6, 2009.

<sup>2</sup> "IMF says world economy is recovering", *Financial Times*, Chris Giles, October 1, 2009.

further imbalances. Europe, and in particular Germany, appears determined to simply wait for growth in the rest of the world to export itself out of recession. However, in addition to the prospect of slow U.S. growth, Europe faces significant internal difficulties, especially with deteriorating demographics, rising fiscal debt issues, and problems with the Eastern and Southern European countries. Problems in Eastern Europe and increasing difficulties in Southern Europe will hold down demand growth within the region. In Japan, economic dormancy, political instability and not to mention the world's worst demographic profile are likely to continue to suppress domestic demand. In the rest of Asia, emerging market economies will also continue to depend heavily on exports to generate growth and foreign reserve accumulation through foreign exchange manipulation. China, in particular, looks likely to continue to lean heavily on exports to try to sustain rapid economic growth. In fact, in reaffirming China's growth strategy through foreign exchange management, China's Deputy Central Bank Governor, Yi Gang, reiterated that China will not change the method in which it determines its exchange rate policy despite G-7 nations' call for China to strengthen its currency.<sup>3</sup>

Moreover, the United States is a chronic trade deficit country<sup>4</sup>, looking more like an emerging market country than we do like an advanced industrializing country from that perspective. Our exports are small relative to our imports in percentage terms with most of those imports essentially the result of global supply chain management by our own companies.<sup>5</sup> US companies feel global, they act globally, they operate globally and they try to produce products for American businesses and consumers that make them the most money wherever they actually do the assembly. This part of our import profile will not change. Additionally, the US would face exorbitant inflation would it not be for the vast amount of goods we import from such countries as China where we import over \$350 billion annually.<sup>6</sup>

What does this all mean? Global growth will gravitate from the developed countries towards the emerging economies. That said, even the best performing emerging countries will not go back to the peak growth rates they experienced from 2004 through 2007. Nor will their economic outperformance be universal: the biggest, most economically developed emerging markets are less dependent on US consumption than previously thought and they have greater wherewithal to respond to economic crisis, building and holding vast foreign reserves for these reasons. Putting figures to the discussion, emerging economies will grow much more quickly than advanced economies, with growth averaging 5.1 per cent in the emerging world, even including the troubled central and eastern European regions, and only 1.3 per cent in the developed countries.

Additionally, the public sector will strong-arm the private sector for some time while central banks and governments find it difficult to coordinate and implement effective exit strategies.<sup>7</sup> The Fed and other Central Banks will have to replace the former shadow banking system as a means of financial intermediation. What is crucial to realize is that the U.S. as well as numerous other developed economies are in an increasingly poor position to compete in a global economy where capitalism is slowly transforming from its emphasis on finance and levered risk taking to a more conservative, regulated, production and manufacturing-oriented system benefited by countries focusing on savings.

From a geopolitical and geo-economic standpoint, in light of the most recent G-20 communique, changes in consumption and trade patterns will have profound implications for the dollar, globalization and the willingness of countries and regions to explore new alliances and multilateral trade agreements. There is no magic here for what is needed for sustained global growth. The proper steps have been outlined and discussed in both academia and political circles. However, what is lacking is the current political will on the part of global economies, both developed and developing, to take the necessary steps for proper reform.

### **G-20 in Pittsburgh: Results & Implications**

The world leaders that comprise the G-20 met in Pittsburgh and addressed several pressing issues. Included in their final communique were discussions of avoidance of premature exit strategies, agreement to coordinate their exit strategies in a systematic manner<sup>8</sup>, develop an international financial framework for *strong, sustainable and balanced growth going forward* and

<sup>3</sup> "China remains firm on renminbi policy", *China Daily*, 10.5.2009.

<sup>4</sup> Part of the reason being its status as the reserve currency country – a topic we will cover in future musings.

<sup>5</sup> "At G-20 Economic Summit", Council on foreign Relations, Roger M. Kubarych, September 24, 2009.

<sup>6</sup> China needs to continue its export-oriented growth policies until its domestic demand-oriented policies particularly in the infrastructure investment area, kick in full throttle.

<sup>7</sup> "A New Normal", *Secular Outlook*, PIMCO, Mohamed El-Erian, May, 2009.

<sup>8</sup> "We will avoid any premature withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a cooperative and coordinated way, maintaining our commitment to fiscal responsibility," the final statement said.

agreement to implement policies to strengthen financial regulation with reformed rules on fractional reserve capital requirements and employee compensation. Other initiatives included reforming the global institutional architecture, including reallocation of quotas and voting within in the IMF, phasing out fossil fuel subsidies, bringing the Doha round to a successful conclusion in 2010, and reaching an agreement in Copenhagen on climate change.<sup>9</sup> From a current policy perspective, the G20 agreed it was too early to begin to scale back the multi-trillion dollar stimulus measures that have helped stave off further economic misery following last year's financial meltdown. Let's quickly address some of the salient points.

The G-20 at the request of the Obama administration argued that all issues about the reform of the IMF should be on the table, including whether the US should retain its de facto veto at the IMF. The US believes it has already made a concession by keeping its IMF shareholding at 17 per cent, well below its share of global GDP. Since IMF board decisions require a super-majority of 85 per cent, the US retains effective veto powers with a 17 per cent voting share. It was agreed that there would be a shift of at least 5 per cent of its internal voting rights to the developing world at the expense of EU voting power and tasked it with a bigger monitoring role.<sup>10</sup> White House officials declined to comment, with one European official saying the US had decided not to press this matter further in Pittsburgh. But the dispute added to the growing sense of irritation between the major European countries and the Obama administration.

Another bone of contention between the US and the EU has been the issue of global imbalances. Angela Merkel, Germany's chancellor said the fight against global economic imbalances should not become the central issue at the summit – in contradiction of Barack Obama's stated objectives.<sup>11</sup> Speaking in Berlin before boarding her flight, Ms Merkel came close to accusing the US and Britain of backtracking on financial market regulation and global limits on bankers' bonuses by shining the spotlight on the export-oriented economic policies of Germany and China. "We should also look at imbalances between currency regions and not pick on specific countries within the Eurozone," she added, referring to criticism from the US that Germany is not doing enough to support its domestic demand. She has made it a focal point of her approach to the G-20 meetings to emphasize that every financial product, institution and location must be made subject to regulation, diverting discussion from global imbalances.<sup>12</sup> We emphasize this particular issue of the G-20 for two reasons. First, we believe that an extremely strong US-EU relationship is of utmost importance both geo-economically and geopolitically. President Obama, in our opinion, has failed to build on the very positive response the EU bestowed upon him when he was first elected. Second, as we will discuss later, ***we believe that sustained global growth cannot be achieved without addressing the issues of global imbalances and as discussions/developments at the G-20 meeting indicate, consensus and political will is far from concrete.***

Another issue which we single out is one of exit strategy implementation. The G-20 is correct to conclude that there will be no premature exits from macroeconomic stimulus and to reassure the world that monetary tightening can be technically manageable. The exit strategy needs greater international coordination. Credible commitments to medium-term fiscal consolidation should precede monetary tightening to pre-empt Volcker-Reagan policy mismatches which drive up interest rates.<sup>13</sup> There is also a pressing need for international coordination of policy exits.

For example, when there are positive spillovers from stimulus programs of one country to another, the absence of coordination will lead some countries to restrain their efforts at stimulating their economies.<sup>14</sup> Conversely, when one country starts a policy of fiscal contraction, this will reduce economic activity domestically – and also negatively affect economic activity in the other countries. As a result, the other countries find themselves in a worse situation – economic activity declines and this in turn tends to increase their budget deficits. They are likely to respond by following restrictive budgetary policies, thereby reducing economic activity both domestically and in the other countries. Without proper coordination, the reduction of the budget deficit by county A injures country B. The latter will experience a decline in economic activity and an increasing budget deficit. This process triggers a further deflationary dynamic that hurts everybody and complicates the task of reducing the budget deficits everywhere.<sup>15</sup>

<sup>9</sup> "G20 takes Charge", *Financial Times*, September 27, 2009.

<sup>10</sup> "Tensions over IMF threatens to mar G20", *Financial Times*, Edward Luce, September 24, 2009.

<sup>11</sup> "Tensions over IMF threatens to mar G20", *Financial Times*, Edward Luce, September 24, 2009.

<sup>12</sup> "Merkel Wants G-20 to Focus on Financial Regulation", *Wall Street Journal*, September 24, 2009.

<sup>13</sup> "How to Prevent an Unruly Rush for the Exit", *Financial Times*, Adam S. Posen, September 17, 2009.

<sup>14</sup> "To coordinate or not to coordinate", VoxEU, Paul De Grauwe, September 24, 2009. This is often called the "free riding behavior" that was intensely discussed in the 1970s and 1980s.

<sup>15</sup> "To coordinate or not to coordinate", VoxEU, Paul De Grauwe, September 24, 2009.

By analogy, an unruly rush to the exits is no better in a global financial crisis than in a crowded theatre. The challenge is getting through the exit together safely. If the G-20 successfully manages that process, the policy measures undertaken will provide strong building blocks for a sounder future regime - but we cannot emphasize more the need first to get to the point where we truly need an exit strategy first before we can develop a sound strategy. The “Anglo-Saxon” countries, i.e. the US and UK, are likely to hit the problem of unsustainable budget debts and deficits sooner than the Asian countries. They will be pressured to exit first, but they are also the countries that can least afford to do so first. An early exit strategy by these countries could set in motion the deflationary debt dynamics in a more intense way than in the Asian countries. We believe these differences are likely to make a coordinated approach to fiscal exit strategies very difficult. **Only such a systematic and universally coordinated approach can achieve sustained success.**

## Global Macro-Economic Outlook

The global economy now appears to be turning the recovery corner after coordinated efforts of central banks and treasuries to provide Keynesian and monetary stimulus. Global GDP growth is tracking 4%-5% for the third quarter, led by Asia, which grew 12% in the second quarter. What remains to be seen is how sustainable this recovery is once these stimulus programs begin to be unwound. Given the level of global government stimulus, we should not be surprised to see green shoots popping everywhere. In fact, the entire world economic rebound in 2009 and then some is being accounted for by fiscal stimulus. There is still no credible sign that the global recovery is being sustained by organic private sector activity. Additionally, for 2010, 80% of the growth that the consensus is penning in is derived from the public sector.<sup>16</sup> Moreover, much of the recent improvement reflects companies rebuilding inventories, and is boosted by China's rebound according to Marco Annunziata, chief economist at Unicredit. “I’m worried that the world economy doesn’t have the stamina to keep growing.”<sup>17</sup> There has never been a recovery more reliant on monetary and fiscal stimulus than this one as most prior rebounds did not require much stimulus at all. A similar trend is found in China, when looking at the amount of recent loan growth needed to generate a unit of real GDP. We get the same feeling when looking at stimulus elsewhere, e.g., Swiss and Hong Kong monetary base growth over 100%, fiscal stimulus of 8%-10% of GDP in Brazil, Russia, and Malaysia.

Where will growth come from in the Anglo-Saxon developed countries? With respect to the US, it would be very heartening to see a revival fuelled by capital investment but when over one-third of manufacturing capacity is sitting idle, that is not very reasonable an expectation. Similarly, considering that exports comprise little more than 10% of GDP, the foreign sector is hardly going to be adding a whole lot of potential to the GDP data, at least over the intermediate term. We are therefore left with government and public sector. However, when the inventory replenishment and stimulus fades, the West will reawaken to the reality of a consumer leverage binge now infecting the public sector as well. We are therefore faced with the question as to what will constitute sustainable growth without public stimulus....

## Sustainable Growth & the New “GI” Bill<sup>18</sup>

It has become a quite widespread belief and prediction among commentators and academia that the global economic landscape has changed fundamentally for some time to come. Emerging countries which were in the midst of severe economic crisis just one decade ago are now in a position to demand more say in our international institutions as the developed world is becoming more dependent on them. In run-of-the-mill economic downturns, economies bounce back in a predictable manner. For example, to fight recessions, central banks lower interest rates resulting in increased demand and output. Consumers start consuming again and companies start investing in capital and equipment. Simultaneously, exchange rate depreciation gives a boost to the export sector. Lower growth during recession is augmented with higher growth during recovery until the economy returns to its normal long term growth path, determined by such factors as demographics, capital, labor and productivity.

<sup>16</sup> “Breakfast with Dave”, Gluskin Sheff, David Rosenberg, September 9, 2009.

<sup>17</sup> “Industrial output on the rebound”, *Financial Times*, August 3, 2009.

<sup>18</sup> By “GI”, we refer to “global imbalances” which in turn refers to the pattern of current account deficits and surpluses that built up starting in the 1990s and with the US and some other countries (UK, southern European countries, and Eastern Europe) developing large deficits and other countries (China and other east Asian countries, Japan, Germany and the oil exporters) developing counterbalancing surpluses.

This downturn is far from ordinary, however. Many parts of the economy such as financial intermediation through securitization and the shadow banking system have become largely dysfunctional. Additionally, changes in the composition of global demand as consumption shifts from developed to developing countries will no doubt require changes in the structure of production.<sup>19</sup> This shifting could translate into lower potential output for years to come. We have to remember the root causes of this crisis to truly understand the consequences and what it will take to make any attempted recovery sustainable.

From 1980 through 2007, the world's financial assets nearly quadrupled in size relative to global GDP while global capital flows surged in a similar fashion.<sup>20</sup> Credit bubbles grew prior to the crisis in the US with total US credit outstanding rising from 221% of GDP in 2000 to 291% of GDP in 2008.<sup>21</sup> During this time period, the federal government borrowed from abroad to finance its federal budget and the private sector borrowed to consume beyond its means. The result of all this borrowing was a broad-based but unsustainable surge in both domestic and global economic expansion.<sup>22</sup> During the period between 2000 and 2008, current account deficits were running between \$500 billion to \$1 trillion annually. Moreover, this borrowing was not going into investments to add to the productive capacity of the economy but was funneled into the financial and real estate sector that created the housing bubble. In turn, the housing expansion fed into a broader expansion of consumption as debt fed housing price increases that enabled more debt through the Housing ATM-effect.

Let's put this debt in perspective. Total US debt as of June 30<sup>th</sup> stood at \$52.8 trillion. This figure does *not* include liabilities such as non-funded pensions, unfunded liabilities for Social Security and Medicare and other government programs as well as other off-balance sheet financing. When compared to national GDP of \$14.2 trillion, we get a total debt-to-GDP level of over 373% which is unprecedented. The most disturbing issue of this debt is not the absolute levels of this debt but first, the assets that were purchased with this debt are falling in price, and the money that was borrowed to purchase the assets were often fraudulently borrowed because neither borrower nor lender expected the debt to be repaid but that asset prices would extinguish the debt.<sup>23</sup> At the national level, US government debt stood at over \$9.6 trillion by the end of September of 2009. Relative to the size of its economy the debt to GDP ratio for the US stood at 60.8%. In contrast, the national debts of France and Canada are similar, standing at 68.1% and 63.8%, respectively.<sup>24</sup> Italy's debt to GDP stands at over 100% while Japan's is a staggering 173%. For the emerging markets of India, the national debt stands at 61.3% of GDP while China's is a mere 16.2%. That said, the US debt load is not that out-of-line with other major countries.

From a historical perspective, the federal deficit has been much higher in the past. At the end of World War II, the US national debt was 130% of GDP.<sup>25</sup> That said, since 1945, the economy has generally grown faster than the debt. As a result, in 1974, the debt-to-GDP ratio reached a post-World War II low of 23.9 per cent, and as recent as 2007, it was only 36.9 per cent.<sup>26</sup> By contrast, today's prospective deficits dwarf the probable future economic growth. The problem which we will discuss in greater detail below is that the US will find it very compelling to grow faster than its debt trajectory because its aging demographics is changing its economy structurally and decreasing its potential GDP growth.<sup>27</sup> Every quarter, the U.S. Department of Commerce releases an estimate of what is known as "potential GDP," as well as estimates of future potential GDP for the decade ahead. These estimates are based on the U.S. capital stock, projected labor force growth, population trends, productivity, and other variables.<sup>28</sup> *In the most recent figures, because of demographics and other factors, projected 10-year growth in potential*

<sup>19</sup> "Sustaining a Global Recovery", *Finance & Development*, September 2009.

<sup>20</sup> "Global capital markets: Entering a new era", *McKinsey Quarterly*, September 2009.

<sup>21</sup> "Global capital markets: Entering a new era", *McKinsey Quarterly*, September 2009. Eurozone indebtedness rose even higher to 304% of GDP by the end of 2008 while UK borrowing climbed even higher to over 320%

<sup>22</sup> "Reflections on the Causes and Consequences of the Debt Crisis of 2008", La Follette Policy Report, Menzie Chinn and Jeffrey Frieden, Fall 2009. This was a result of a "capital flow cycle" in which foreign capital floods a country, stimulates an economic boom, encourages financial leverage and risk taking, and eventually culminates in a crash.

<sup>23</sup> Quarterly Review and Outlook – Third Quarter 2009, *InvestorInsights*, John Mauldin.

<sup>24</sup> "Debt Be Not Proud: The Sorry Tale of America's Out-of-control Spending", *The Journal of the American Enterprise Institute*, John Steele Gordon, September 7, 2009.

<sup>25</sup> However, we have to keep in mind that in 1945, 90% of the deficits were all defense related and easier to reduce once war was over. Today, most of the deficits are structural and by 2016, over 70% of the deficits spending will be of a mandatory, nondiscretionary nature.

<sup>26</sup> "Ducking the Deficit Issue", *Washington Post*, Robert J. Samuelson, August 31, 2009.

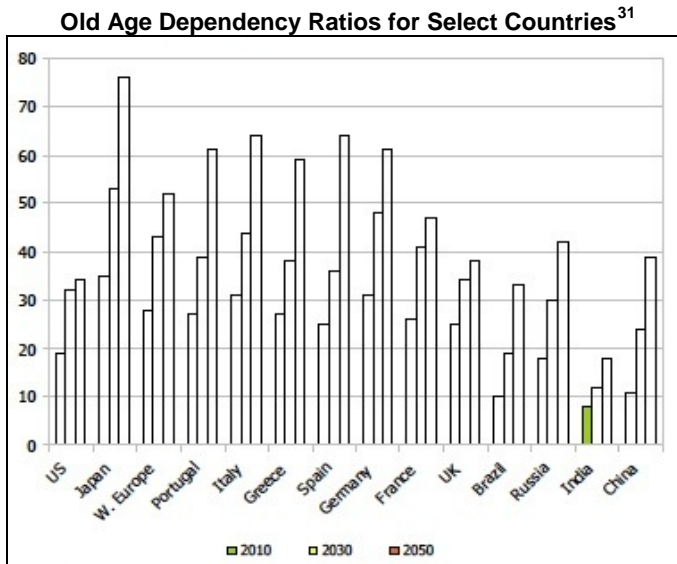
<sup>27</sup> An added problem today is the debt is rising very rapidly in absolute terms and relative to GDP. For 2009, the federal budget deficit is estimated to be a staggering \$1.6 trillion, the largest peacetime deficit which will cause the debt to GDP to rise to over 80%. The Obama administration's latest projections, released last week, show nearly \$11 trillion of borrowing from 2009 to 2019. In 2019, the debt-to-GDP ratio would be 76.5 percent. This could be too optimistic, because it assumes some spending restraint and tax increases. In comparison to other countries, the IMF predicts that the G20 advanced countries' debt to GDP to increase from 80% on average in 2007 to over 110% in 2010. "A pattern emerge", *Financial Times*, Chris Giles, September 20, 2009.

<sup>28</sup> "Growth in "Potential GDP" Shows Limited Potential", John Hussman, Ph.D., September 25, 2009.

GDP has never been lower. This is not based on credit conditions or other prevailing concerns related to the recent economic downturn. Rather, it is a **structural** feature of the U.S. economy here, and has important implications for the sort of economic growth we should expect in the decade ahead.<sup>29</sup>

### The Aging Demographic

Before we move on another topic, let's briefly give more detail on one important issue that will have significant ramifications on the global economic framework going forward, namely the area of the aging population in many countries. Let's first look at the relationship between a country's demographics and its current account deficits. According to the Life Cycle Hypothesis, as the elderly population of a country dominates the younger population in terms of numbers, a country goes from current account surplus to one of deficits.<sup>30</sup> In other words, as the population grows older, the country needs more and more exports to prevent unsustainable current account deficits.



Upon analysis of the chart above, most of the OECD countries are quickly approaching the danger zones which a large part of the population consists of pensioners. The higher the dependency ratio, the fewer working people there are to pay for the elderly. At some point the cost of supporting the elderly will reach a level which will prove unsupportable and some of the more exposed countries may quite simply be forced to cut back or abandon their welfare programs for solutions. From the charts, it is quite evident that Japan is in the worst situation of all. Japan has been mired in economic malaise for over two decades and it is of little wonder how much Japan's demographic woes have played in its economic problems. The outlook for Europe is not that much better than Japan given its lower savings rate and higher cost of its welfare model.<sup>32</sup> Lastly, based on a recent study commissioned by the European Commission, budgetary effects of the projected demographic trends are much larger than the cost of any stimulus packages.<sup>33</sup> In fact, the IMF has forecast fiscal costs of future increases in entitlements will be 10 times the costs of the crisis. For this reason, we believe demographics and age-related spending are topics that should be an integral part of any global macroeconomic outlook.

As we stated earlier, the OECD countries are getting older and will need greater amounts of exports to support their larger current account deficits and age-related spending. However, we cannot all become export countries and this fact brings us to our thesis of what it will take to bring about healthy sustainable growth. We believe that there are two components to this story.

<sup>29</sup> "Welcome to the New Normal", John Mauldin, September 25, 2009. The likely growth rate is still below 3% annually over the next decade.

<sup>30</sup> "A Country for Old Men and a Bit of Samba", Mauldin's Outside the Box, Niels Jensen, October 5, 2009.

<sup>31</sup> Defined as the number of people 65 and older for every 100 people between the ages of 15 and 64 (which defines the working population). Source: United Nations.

<sup>32</sup> "A Country for Old Men and a Bit of Samba", Mauldin's Outside the Box, Niels Jensen, October 5, 2009. The IMF has calculated that the cost of age-related spending in the average advanced G20 country will cause public debt-to-GDP to grow to over 400%, with Spain and Greece reaching over 600% unless the existing welfare model is cut back. For comparison, Japan has the highest public debt-to-GDP ratio today at about 225%.

<sup>33</sup> "The risky game of chicken between Eurozone governments and the ECB", Francesco Giavazzi, September 21, 2009.

The first component will require **rebalancing public and private spending**. *We are not in disagreement that major fiscal and monetary stimulus was needed to revive the global economy from the grips of economic disaster.* No democratically elected government can stand on the sideline in nonfeasance when its constituency faces such a dire situation.<sup>34</sup> Governments inevitably find themselves dragged in to address the mounting damage to human welfare increased government spending and lower taxes in return for larger fiscal deficits and increasing debt from already unsustainable levels. Fiscal stimulus and deficits in developed countries cannot last too much longer, especially given the demographic characteristics we explained earlier. Eventually, fiscal stimulus must be phased out and private demand must replace it. The source of that demand – consumption and/or investment – is a crucial issue that brings us to our next challenge.

The second component of sustainable growth will require **rebalancing demand across countries and regions**. As we stated above, we cannot all export our problems away as we grow older and domestic demand begins to fade. The *only* way out, if we want to maintain economic growth, is for the younger and more dynamic emerging economies to become net importers i.e. increase their domestic consumption and older net-import countries need to decrease imports and increase exports. This process which we now pen, the “**New GI Bill**”, will be needed to eliminate the vast global imbalances that were built up from the period of 2000 to 2007. This will require a 180° change in policy and attitude in those countries.

In order to quantify these imbalances, if we add the absolute value of all global current account deficits and surpluses, then divide by two, we get an approximate metric for global imbalances. They were about 1 per cent of world output during most of the 1970s, '80s and '90s. **Since 2000, the global imbalances have tripled.**<sup>35</sup> Rebalancing is likely to occur eventually as countries with export-driven development strategies such as China will have to boost their domestic demand as they export less and begin to import more. Countries such as the US and UK need to become fiscally leaner as they consume less and begin to export more. At the same time, these younger, surplus countries will have to pick up the slack left by the US.

#### **So what countries are likely to participate in the New GI Bill?**

Let's first look at the US. For many years, the US consumed more than it produced and saved. We borrowed on the misperception that the “Great Moderation” had suspended the old rules of business cycles. From the standpoint of the US, we are already seeing an unwinding of debt accumulation. For households, savings rates are increasing at the cost of stagnant/decreasing consumer spending. At the corporate level, debt retrenchment is translating into reduced rates of investment in plant and equipment in light of historic low levels of capacity utilization. The US government will also have to increase its savings to deal with the massive fiscal deficit that has opened up in part due to the financial crisis and in larger part, due to the structural changes of the US economy. Therefore, it can be expected that national savings in the United States will rise substantially in the period ahead and this adjustment in the U.S. savings and investment imbalance will take place as the current account deficit narrows. If a prolonged US recovery is to take place, government stimulus must be phased out and exports must increase given private demand will be weak. Consequently, demand in the United States over the next decade or so will grow substantially slower than it has in the preceding three decades. The world can therefore no longer rely on the US consumer (and other countries running huge current account deficits, such as the UK). Who will take her place, is the next big question.

Perhaps let's consider the Asian countries and China, specifically. Pan Asia ex-Japan is considered to be the bright spot in the world economy for the time being. These emerging market economies in the region have been judged to have weathered the economic and financial crisis far better than the advanced countries and better than expected. The perceived strength in economic activity in Asia at present looks to be associated with a temporary recovery in growth largely owing to inventory rebuilding and continued effects of monumental fiscal and monetary stimulus measures. While Asia may be looking better than expected in 2009, economic prospects for the region for the short-term in the absence of major changes in economic policies, we believe, will remain heavily dependent on recovery and growth in the advanced countries. For example, the most recent move by Chinese treasury authorities were to intervene in the foreign exchange markets and support the US dollar amid fears that their exports could be losing ground.

<sup>34</sup> “A New Normal”, *Secular Outlook*, PIMCO, Mohamed El-Erian, May 2009.

<sup>35</sup> “How toxic finance created an unstable world”, *Financial Times*, Wolfgang Munchau, August 23, 2009.

Rebalancing China's economy requires removing price distortions and enactment of other policy changes to eliminate inefficiencies and incentives favoring investment over consumption.<sup>36</sup> Serious distortions exist in the pricing of energy, other utilities, land, and pollution abatement; but, as noted above, the major price distortions are the low cost of capital and the undervalued exchange rate. Capital costs need to be raised significantly, and this cannot be done without permitting more flexibility and a more rapid rate of appreciation of the exchange rate. In addition, the government has an important direct role to play in rebalancing the economy and creating "social safety nets." For example, it has to continue improving critical social services such as education, health care, and pensions. Reducing the uncertainties surrounding the provision of these services will substantially diminish households' strong precautionary savings motive and give households the confidence needed to raise consumption.

A number of other countries with current account surpluses can help pick up the slack. For example, Germany had half of the surplus that China had in 2008 while Japan's was one third of China's. Let's look at Europe first. Because Germany which is the major economic locomotive of the European Union, it cannot follow an exchange rate adjustment path that Asian countries can to help eliminate global imbalances. From the demand side, Germany is largely in the same position as the US from a fiscal perspective. Moreover, Europe and Germany in particular, are *unlikely* candidates to pick up the slack from lower US growth because they look very likely to remain dependent on exports to drive their economies. This situation reflects in part a sense of complacency among the Europeans and a lack of political will, especially in current circumstances, to implement some difficult, but necessary, policy measures.<sup>37</sup> The complacency of the Europeans arises from their view that they are victims in the current economic and financial crisis and see justification in the economic policies that they have followed. In particular, they argue that they have developed a competitive advantage in the export of certain types of goods, and exploiting this advantage was a major impetus to growth in the period before the current crisis. They see no reason to change this basic model for growth. This was clearly their stance during the recent G20 meetings where Angela Merkel clearly made it clear global imbalances were not on the top of here agenda.

Japan also cannot be expected to do much to pick up the slack in world demand. The country appears to be on the verge of slipping into its second major deflation in the past two decades, and it will remain dependent on exports for economic recovery and growth. At this juncture, the best the authorities are able to do is to try to limit the slide in the economy through some monetary and fiscal policy actions.

Therefore, it appears that both China and Europe are likely to continue with broadly the same policies, trying to rely on exports for future growth while failing to produce sufficient **sustained long-term** domestic demand. Therefore, if all we do is stimulate the economy in the short term through monetary and fiscal policies, and tighten financial regulation, we are not solving the problem but applying plenty of Band-Aids®. Without an increase in domestic demand from Europe and China, there is nothing to take up the slack created by the saving of the US private sector. Once the US stimulus expires, and the budget deficit starts to narrow, global demand will settle at a new lower level. Under those circumstances, it is difficult to see how the world economy can return to the pre-crisis levels of growth rates, or even close to them.

*In summary, we believe that sustained economic recovery will require delicate rebalancing acts, both within and across countries in a globally coordinated manner. Returning to the extraordinary global growth rates realized from 2000 to 2007 where global output expanded at unprecedented levels as a result of massive debt expansion is highly unlikely.* During that period, we saw the relatively young emerging market countries save vast disproportionate amounts of their output and export their way into new found wealth. At the same time, these savings were funneled to aging, developed countries that were spending well beyond their means. This debt creation produced these unsustainable global imbalances. Once it became apparent that this could no longer go on as global investors finally began to correctly perceive and value the risks of these imbalances, the bubble popped and the crisis began.

***Because the aging developed country big-spenders are tapped out, we need a strategy that will bring both spenders and savers into economic equilibrium via the "New GI Bill". This will require tremendous political will as well as global institutional mechanisms that do not currently exist, evidenced by the lack of concrete directives at the G20 meeting or proposals by the IMF. For the US, political incentives such as cash-for-clunkers and***

<sup>36</sup> "The Gloomy Prospects for World Growth", Council on Foreign Relations, Steven Dunaway, September 2009.

<sup>37</sup> "The Gloomy Prospects for World Growth", Council on Foreign Relations, Steven Dunaway, September 2009.

***housing tax subsidies continue to favor domestic consumption, especially given that mid-term elections are around the corner. For Chinese President Hu Jintao, solutions to global imbalances means smaller trade surpluses, which would translate into millions more workers in export-oriented manufacturing industries being unemployed – clearly an undesirable and socially unsustainable outcome in the short to intermediate term. For German Chancellor Angela Merkel, encouraging and increasing domestic consumption means discouraging investment in the capital-goods industries that have played such a critical role in the country's economic revival. For Japan's new Prime Minister, Yukio Hatoyama, a more balanced global economy would imply further weak export growth at a time when Japanese manufacturers already are struggling due to weak foreign demand.<sup>38</sup> Put another way, in the private sector, if John the Plumber continually consumes beyond his means and does not eventually adjust, he files bankruptcy to reach legal equilibrium. At the sovereign level, however, we do not have International Bankruptcy Court but an effective alternative is deglobalization through protectionism and in extreme circumstances, potential armed conflict as clearly evidenced by history, a path to be avoided at all costs.***

From a macro-economic standpoint, what happens if these imbalances are not resolved? It's called the ***New Normal***.....

### **The New Normal<sup>39</sup>**

Based on an in depth study by the IMF of over 88 banking crises over the past 40 years in multiple countries, on average, economic output does not go back to its old pre-crisis path but remain permanently below it. The study does conclude that while crises lowers the level of output, the trend, or growth rate of economic output does not change.<sup>40</sup> However, while we hesitate to say that it is different this time, we think that it is truly different this time because the world has changed in a way that is unlikely to be reversed any time soon.

***It is apparent that there is massive overcapacity in the U.S. and the global economy, with conditions only getting worse. With a significant break in previous growth patterns will come a period of deleveraging, deglobalization and reregulation, or the New Normal. The New Normal will be characterized as a period of time in which economies grow very slowly and profits are relatively static. Governments play significant roles in terms of deficits and reregulation and control of their respective economies. And consumers stop shopping beyond their means and start saving. Consumption patterns will be redirected from deficit countries to surplus countries.<sup>41</sup>***

Why is this the case? The “Great Moderation” during the past two decades allowed US to spend beyond its means and issue paper debt that was accepted by emerging countries all over the world because of the depth, breadth and liquidity inherent in the US capital markets. Emerging countries manufactured goods sold to the US in return for this paper payment. While it was great while it lasted, we are seeing this mercantilism coming to a stop. Unless global imbalances are not addressed, slow growth will be upon us for some time. Government is taking over industry like never before, reregulating and replacing the shadow banking system, only to lead to lower growth and profits down the road. Finally, global leadership and unipolarity of the US as a reserve currency has been called into question. These are the issues that face the US economically and will most likely lead to lower growth, higher interest rates, higher inflation or a combination thereof. While fiscal and monetary stimulus can prove effective short term palliatives for economic growth, they will not be strong enough to return to the high growth and low inflation that characterized 2000 through 2007.

Nominal GDP needs to grow close to 5% in order for the economy's long-term balance to be maintained. Otherwise, employment levels become unsustainable (resulting in higher structural unemployment), retail shopping centers unserviceable, automobile production facilities unprofitable, and the economy itself heads towards the New Normal where unemployment averages 8 instead of 5%, housing starts total 1.5 instead of 2 million, and domestic auto sales 12, instead of 16 million annual units.<sup>42</sup> A portion of the US productive capacity and labor markets will have to be permanently laid off.

<sup>38</sup> “Return of the old ways of thinking threatens recovery”, *Financial Times*, Mohamed El-Erian, September 28, 2009.

<sup>39</sup> This phrase was first penned by Mohamed El-Erian of PIMCO.

<sup>40</sup> “Crisis and Recovery”, World Economic Outlook, International Monetary Fund, April 2009.

<sup>41</sup> “On the “Course” to a New Normal”, *Investment Outlook*, PIMCO, Bill Gross, September 2009.

<sup>42</sup> “Investment Potions”, PIMCO, Bill Gross, August 2009.

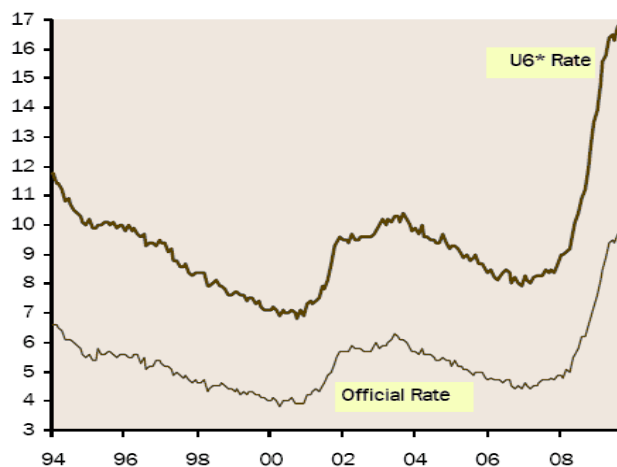
Over the next 3 to 5 years and perhaps beyond, we expect benign global growth within a framework of output gradually shifting from the developed world to the emerging world, led by China and India.<sup>43</sup> It appears that the US and the UK will slowly recover in the context of very slow, or below trend output. Europe will also grow slowly partially as a result of its central bank's sole mandate of inflation management and concerns over the structural integrity of the European Union caused by friction from southern and central European countries. The Emerging markets will be categorized into two groups: the first with weak economic fundamentals and heavily dependent on IMF and World Bank funding and the second group, such as the BRIC countries, will maintain their development phase but not at the artificially high growth rates of the past decade.

## Capital Markets Outlook

### US Economic Outlook

Let's begin by reviewing some of the most important economic data released by the government. First, let's consider recent employment data. Nonfarm payrolls came in at -263K versus the 175K that was widely expected, with a sequential deterioration for the first time since May. *Additionally, the most all-inclusive measure of unemployment, the U6 measure, which includes the shift to part-time work, has already hit 17% in September, 0.2% higher than August. The comprehensive measure of labor underutilization accounts for people who have stopped looking for work or who can't find full-time jobs. The U-6 figure is the highest since the Labor Department started this particular data series in 1994.*<sup>44</sup> Why do we view this as disturbing? The current gap between the U6 and the official measure is 7% versus a historic gap of 4%.<sup>45</sup> As the gap mean reverts to 4% - U6 heads down and the official rate moves up, the 4% could easily translate into a headline inflation rate of ~ 13%. To see why this happens, as employers feel the need to add labor, they first boost hours and move the record number of employees out of part-time out of furlough and back into full employment. However, the 100,000 to 150,000 new entrants to the labor force will continue to find it difficult to find full employment and thus the headline unemployment number will continue to rise despite economic recovery beginning to emerge. **Therefore, in addition to the 6.9 million positions lost during this downturn, we have to count in the additional 2.5 million jobs that need to be created just to accommodate the new entrants into the labor market, translating into a real unemployment rate of over 16.8%.**

**U6\* Rate versus Official Rate**  
(percent)



**Spread between U6 and the Official Unemployment Rate**  
(percentage point)



\*Includes all marginally attached workers and those employed part-time for economic reasons

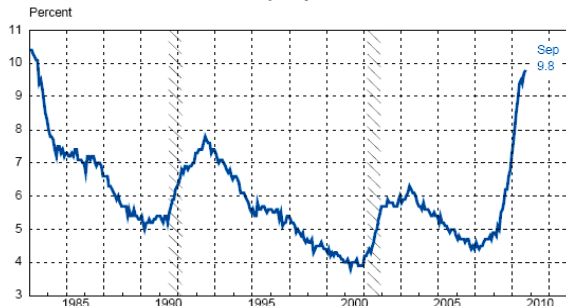
Source: Haver Analytics, Gluskin Sheff

<sup>43</sup> "A New Normal", *Secular Outlook*, PIMCO, Mohamed El-Erian, May 2009.

<sup>44</sup> "Historical US Unemployment", *Wall Street Journal*, October 2, 2009. The U-6 figure includes everyone in the official rate plus "marginally attached workers" — those who are neither working nor looking for work, but say they want a job and have looked for work recently; and people who are employed part-time for economic reasons, meaning they want full-time work but took a part-time schedule instead because that's all they could find.

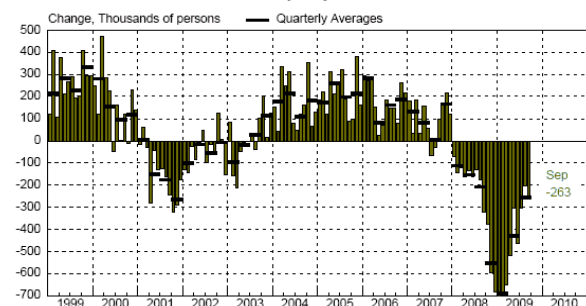
<sup>45</sup> "The Case for Commodities, Credit and Canucks", Gluskin Sheff, David Rosenberg, September 25, 2009.

**CIVILIAN UNEMPLOYMENT RATE**  
Seasonally Adjusted



Note: Household data beginning January 1994 are based on a comprehensively redesigned survey and are not directly comparable with previously published estimates.

**NONFARM PAYROLL EMPLOYMENT**  
Seasonally Adjusted



Source: Bureau of Labor Statistics.

Even great productivity numbers are arguably bad for employment in the particular predicament the US economy is in. Productivity does increase at the tail end of recessions, but what is normal is a 2.5% rate, not the recent 6.4% government print which is unprecedented for this stage of the economic cycle. The reason why companies are so aggressively rationalizing on labor inputs is because their top-line growth is non-existent. Getting 6.4% productivity growth when business output is contracting at a 1.7% annual rate is not a good backdrop — it's actually a detonating backdrop for the labor market. Productivity running at 6.4% is optimal for an economy expanding closer to 8.0% so that we actually get some labor input into the economy.<sup>46</sup>

Moreover, after two years of unprecedented expansion of the Fed's balance sheet and short term rates taken to zero, bank credit is still contracting. Fed data showed continued declines in not only money velocity but outright contraction in the monetary aggregates as well. In fact as the money base has surged over 50%, money aggregates such as M1 and M2 have decreased over that time period as the money multiplier is still contracting. The Fed, along with other government agencies has replaced the private banking system with taxpayer-funded credit. Bank lending to the private sector plunged some \$40 billion by mid-September which represents an unprecedented rate.

The banks are still sitting on over \$1 trillion in cash assets, and they are putting the proceeds to work in the government bond market, snapping up over \$50 billion of Treasuries and Agencies in September alone.<sup>47</sup> The latest data indicate that the Fed's reserve creation showed through as cash on bank balance sheets ballooning \$182 billion in September on the month to an all-time high of \$1.076 trillion. The banks are basically lending the Fed's reserve creation right back to Uncle Sam to earn the spread that is artificially created by the government at the expense of taxpayers. Conversely, the major banks are financing the deficit and earning a nice risk-free return in return to help them earn their way back into solvency.

In order to gage the health of the US consumer and consumption trends, we begin with a discussion of consumer credit metrics to get some idea of consumer deleveraging. Based on most recent prints, total consumer credit outstanding fell for the 7<sup>th</sup> straight month, the most since 1991 and the year-on-year % change continues to make new lows. Nominal consumer spending rose 1.3% in August and real expenditures rose 0.9% due to the cash-for-clunkers program which incentivizes consumers to fund their outlays by dragging their savings rate down to 3% from 4%. This is but one of the government gimmicks to prevent consumer savings from going higher.

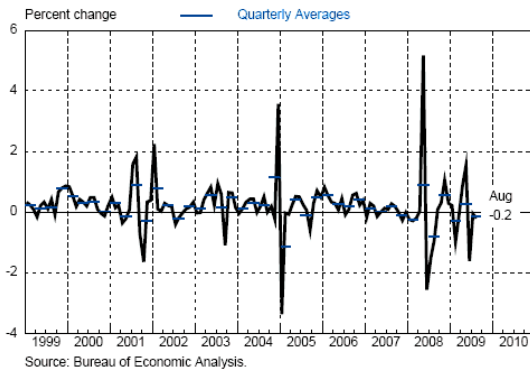
<sup>46</sup> "Breakfast with Dave", Gluskin Sheff, David Rosenberg, August 12, 2009.

<sup>47</sup> During September alone, over 56% of Treasury issuance was bought by foreigners compared to 32% by domestic investment funds — reserve-rich banks looking for high-quality investments earning a positive carry.

Year-on-Year % Change of Total Outstanding Consumer Debt



REAL DISPOSABLE INCOME  
Seasonally Adjusted



PERSONAL SAVING RATE  
Seasonally Adjusted



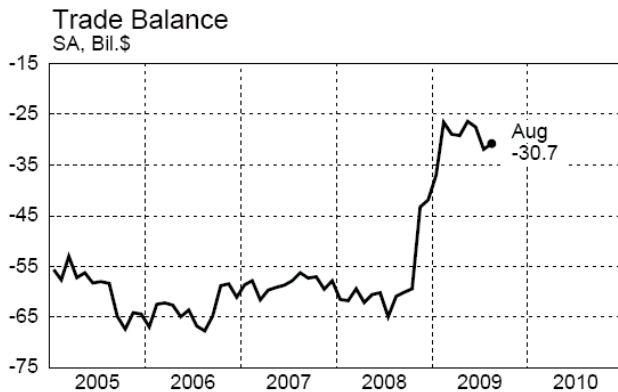
Household income for those in the peak earning years of 45 to 54 years of age plunged \$7,700 from 2000 to 2008 to stand at \$64,349.<sup>48</sup> Only those 54 and older have seen their incomes rise over the past four years as the aging but not yet aged baby boomers re-enter the labour market in droves to garner the income so as to recoup their lost net worth and allow them to at least maintain a comfortable retirement lifestyle. Similarly, based on Census Bureau data, Americans' household income last year took the sharpest drop since the government began keeping records in 1947. Median household income sank 3.6% to \$50,303, after adjusting for inflation, during the first full year of the recession. At that level, median income is now down to its lowest level since 1997 with a decade's worth of gains wiped out in just one year. Those that think we are going to see the return of the U.S. consumer. *This leads us to the belief that the increase in consumption trends cannot occur with a rise in unemployment and savings rates coupled with a drop in real incomes. We believe that the deleveraging US consumer is here to stay which will lead to lower consumption trends.* What GDP component can take its place...

What is one of the bright points of the current economy? With the precipitous drop in the USD and lower US income, net exports have contributed to GDP in a positive manner. First, we began to import less due to the precipitous drop in our incomes. Second, we are exporting more as exports have seen four months of consecutive increases in such sectors as semiconductors and food and beverages.<sup>49</sup> The weakening USD has made US goods and services more competitive.

<sup>48</sup> "Breakfast with Dave", Gluskin Sheff, David Rosenberg, September 21, 2009.

<sup>49</sup> Most recent government data showed that the trade deficit unexpectedly narrowed by \$1.2 billion to \$30.7 billion in August, as exports edged up 0.2% and imports slipped 0.6%.

*With US consumption in stagnation, exports can be an effective way to jump-start the economy but betting on a US recovery on the domestic consumption patterns of foreign sovereign states is a new concept and not without risk given our previous discussion on the need for global rebalancing and the fact that net exports is not a very significant percentage of US GDP, at least for the time being.* That said, if indeed the world begins to rebalance across countries, we can see emerging market growth producing healthy GDP prints in the US. Despite improving net export numbers, however, we have to keep in mind the assault that has taken place in international trade as a result of de-globalization and protectionism since the start of the crisis as well as lack of trade financing. Global trade has shrunk significantly from 2008 to 2009 as a result of these developments.



Source: NY Federal Reserve

What are some of the other positives? The ISM services index joined the manufacturing index on the expansion side of the fence as new orders hit a 23-month high and backlogs are up a record amount. Additionally, better-than-expected chain-store sales came in with the highest reading since December of 2007 suggests that shoppers may be loosening their grip.<sup>50</sup> However, when looking at the retail real estate sector, the picture gets very clouded as nationwide vacancy rates hit new 17-year highs and lease rates continue to plummet (more on this later).

**The Housing Market**

An economic outlook would not complete with a brief discussion of the housing markets. The government data continues to show improvement:

US Existing Home Sales (10.31.2003 – 08.31.2009)



US New Home Sales (10.31.2003 – 08.31.2009)



<sup>50</sup> With respect to chain-store-sales, we have to keep in mind that aggressive discounting increased volume sales, weak comparables from last year make this year's numbers artificially impressive, and only certain segments such as discount stores and teen-oriented stores marked the improvements. Also, keep in mind that many of these chain stores have closed their worst performing stores so that these numbers carry a survivorship bias.

However, upon closer examination of these government prints, the picture is not as rosy. For example, two-thirds of home sales in the summer months were either foreclosures or banks taking a loss on the mortgage. Of the remaining 36%, only 10% are as a result of “normal” or traditional selling between willing buyers and willing sellers not under duress. Moreover, many of these sales are a direct result of government incentive programs such as the \$8,000 first-time home buyer credit for those homes purchased by November 30<sup>th</sup>. This program is working especially at the lower end of home prices with over 30% of home sales in July directly involved with this program. But like “Cash for Clunkers” in automobiles, this is merely fast-forwarding demand for homes from next year into this year. There are millions of homes being brought onto the market through foreclosures - two million vacant homes for sale, plus, builders are still building. At the same time, September data numbers reveal that single-family building permits declined -3.0%, month-over-month, the first monthly decline since March – so much for the green shoots.

In addition to this incentive program, other tax-funded programs are fueling this apparent housing recovery. Part of the bounce-back in housing is the direct result of US government agency programs. The FHA’s share of the mortgage market has ballooned from a residual 3.0% in 2006 to 23.0% currently as the government moves in to replace the private subprime lending industry on the assumption that insuring mortgages with a 3.5% down payment is a good thing for the economy to make the American Dream more accessible and increase the home ownership participation rate. This thought process has resulted in the FHA default rate from 5% to 8% on the taxpayer’s dime. The agency has seen its mortgage business jump 70% in the past year as it is allowing borrowers to finance up to 96.5% of homes priced all the way up to \$729,750. What is the moral of the story? **After excessive debt and living beyond our means got us into this mess, we are encouraging even more debt to get us out, with the taxpayer picking up the tab.** But wait, it gets better.

The positive supply data have been distorted in part because of the inventory that has been held off the market on bank balance sheets which cannot last forever. ***Estimates peg the “shadow” inventory at 7 million housing units - those in foreclosure, those just entering the process, and those that have been in arrears for the past year but have yet to receive a notice. Tack these on to the “official” unsold inventory count of 3.6 million and what we are talking about is an overhang equivalent to 25 months’ supply. With such inventory overhangs, it is truly hard to believe that home prices are doing anything more than a wiggle as they resume a long-term downtrend because of unprecedented government support.***<sup>51</sup> While the subprime market, first-time home buyers and low-income earners have been and will likely remain the primary targets of government relief efforts, the strains in the housing arena are now most intense at the higher end. According to Zillow, 30% of foreclosures are now concentrated in the top one-third of U.S. home values, nearly double the 16% share when the problems in residential real estate were first coming to the fore three years ago. Prime loans now represent 58% of foreclosure starts, up from 44% a year ago.

In addition, there is a wave of interest-only mortgages coming due that will be subject to higher financing costs despite the current low level of interest rates. There are 2.8 million active Interest-Only loans with outstanding principal of nearly \$1 trillion. Considering the rising unemployment rate and it seems very hard to believe that we have seen the peak in delinquency and default rates. We therefore believe that the idea of home prices stabilizing because of a couple of months of relief from the Case-Shiller index may be very premature and ultimately disappointing. This is the case despite the government’s efforts to keep 500,000 in their homes this year through loan modifications.

What about the commercial real sector? We believe that the commercial sector is in the midst of the same economic malaise as the housing sector. As evidence of this development is the record depreciation in office and retail rents. Sales transactions have ground to a halt as credit has completely dried up, as we mentioned above. Equity capital is available in limited amounts but return thresholds have drastically increased making many projects unfeasible. While there are indications that there is a vast amount of equity on the side-lines waiting for distressed deals to come to market, distressed deals are currently available in limited quantities as bankers prefer to work with problem properties through loan modifications rather or retain them on bank balance sheets rather than sell them at distressed prices.

<sup>51</sup> Breakfast with Dave”, Gluskin Sheff, David Rosenberg. More than 300,000 homes are still being foreclosed on every month. The Obama economics team, despite all their best efforts, can barely keep up.

As we presented the case in our previous Commentary, the economic data is mixed at best. Things are better than they were 12 months ago but that is only to be expected. **Clearly, this “recovery” has been the result of government stimulus without any organic private sector growth as of yet. Whether the economy will be able to take the next baby step and walk on its own remains to be seen. The bigger question for the bulls, however, remains the issue of how much of this recovery has already been priced into the US stock market?**

### US Stock Market Performance

**We believe that the US stock markets are overvalued by most metrics that one can use.**

The S&P 500 is up over 55% from the March lows. Never before have we seen the stock market rise so much off a low over such a short time period, and usually at this state, the economy has already created over one million new jobs. Instead, the U.S. has shed 2.5 million jobs (as many as were lost in the entire 2001 recession).<sup>52</sup> The stock market right now has already priced in a V-shaped recovery even though it remains to be seen if we see a V or some other letter in the alphabet. The economic outlook is largely irrelevant at this juncture. It's about how much good news is already being discounted in the equity market. This is an overbought and overpriced equity market and we remain of the view that there is too much risk and too much growth being discounted. Let's look at some metrics.

On a trailing operating earnings basis (\$39.7 EPS), the S&P 500 is currently trading at 27.04. Historically, when the economy turns from contraction to expansion, the trailing operating PE tends to be closer to 15x (calculated of depressed earnings). On a reported basis, the current market is trading at a trailing PE of 143.27x which is unprecedented in history. In fact, during the tech boom, trailing twelve-month reported earning multiples were 27.17x. If we look on a forward basis, the PE on forward operating earnings is 16.49x, the highest in over 5 years and higher than the multi-decade average of 16.1x. In 9 months from the March lows, the S&P went above its previous cycle peak PE which was 5 years old – not a few months old.

From a Price-to-Book value, we have the S&P trading north of 2.2X which is the average multiple for the past 40 years. However, during this stage in the cycle, a more appropriate multiple would be ~ 1.5x which is considerable less than current levels. That said, the market typically faces serious valuation constraints once it breaches the 25x P/E multiple threshold. The average total return a year out for the S&P 500 is -0.3% and the median is -6.2%. The total return is negative a year later 60% of the time. One last metric. Because PEs can be poor short term timing devices, if we use normalized trailing 10-yr earnings, this market is trading over 19x, translating into a 5.2% earnings yield. From a historical perspective, this PE should be in the 14x area to appropriately compensate for the risk taken, given where corporate interest rates are trading.

Looking at it with a different approach, based on a 10-yr triple-B corporate real yield of ~ 7.73% (6.23% nominal yield plus a -1.5% inflation rate), this market is pricing in \$83 in operating earnings. Using consensus forward operating numbers on a top-down approach, going out to 2012, we only get \$81. In so many words, this market is discounting in earnings growth over three years away – growth investing with a stretch. To add injury to insult, only 49% of S&P 500 companies actually delivered upside earnings guidance during the 2Q reporting season. The quality of earnings remains circumspect as only 25% of companies beat their revenue targets in 2Q while S&P 500 sales are down 12% YoY and have posted double-digit declines for three quarters in a row. From a dividend perspective, 40% of the total return in the past has historically been derived from dividend growth. The number of firms raising their dividend plunged 45% from a year ago in the worst third quarter on this basis on record. Meanwhile, 113 companies cut dividends, the most in 27 years.<sup>53</sup> The current dividend yield is approximately 2.0% whereas the historical average has been closer to 5.0%.

Lastly, according to Trim Tabs, corporate insiders were net sellers of their stock by over \$6.3 billion in August with the selling/buying ratio at 30.7x (insiders bought only \$210 million). Not only that, but share buybacks slowed to a trickle in August too — \$3.6 billion, which was the third lowest tally in the past two years.

In summary, these markets are sending us contradictory signals. Since June, the yield on the U.S. 10-year Treasury note has plunged 70 basis points and at the same time the S&P 500 has rallied 14%. **The bond market is telling us that we still live in a deflationary world, yet the equity market is at this juncture pricing in over \$80 of operating earnings, which would be double from the current four-quarter pace.** Moreover, this has been a totally revenue-less

<sup>52</sup> “Breakfast with Dave”, Gluskin Sheff, David Rosenberg, September 217, 2009.

<sup>53</sup> “A V-Shaped Recovery”, Gluskin Sheff, David Rosenberg, October 9, 2009.

recovery as opposed to the recovery in 2003. Corporate revenues were running close to -10% in the second quarter. When the market embarked on its sustained uptrend in 2003, revenues were no longer contracting; in fact, they actually rose at over a 13% YoY rate in the first quarter of that year and never looked back.

### Developed Markets Economic & Capital Markets Outlook: European Union

Our next focus is on the developed markets with the European Union in focus. First, let's review the metrics. With respect to foreign currency, as of the writing of this memo, the \$/€ has appreciated by 5.62% YTD.



With respect to stock market performance, the S&P 500, MSCI EAFE and the MSCI European Indices have returned 21.49%, 27.15%, and 30.27%, respectively.<sup>54</sup> If we back out foreign exchange translation from the European Index, the European markets performed roughly in line with the S&P 500 this year.<sup>55</sup> As the graph below depicts, both the SPX and the MSCI European Index have performed in lock step during the entire year, tracing a correlation of over 70% for the year. The MSCI EAFE has significantly outperformed because upon close analysis, that index includes markets from commodity countries and Asian countries have performed amazingly thus far - more on those subjects to come.

From a valuation perspective, on a calendar 2009 basis, the SPX, EAFE and MSCI Europe are trading at 17.85x, 18.02x, and 14.43x basis. Again, while EAFE can support a larger PE because it contains countries that have and continue to perform significantly better than the remaining developed countries, we focus on the SPX and the European index which clearly shows that the SPX is trading at a significantly higher multiple despite it performing in line with the European Index after adjusting for FX translation. *We believe that the European Index has more multiple expansion to grow and this will be the central reason why this index should outperform the SPX going forward. We think we can hit our bullish case in MSCI Europe over the next 12 months as those markets are trading at 30% discounts to the US compared to the long run average discounts of 20%.*

<sup>54</sup> These figures represent total return performance for YTD as of market close, 10.12.2009, in USD.

<sup>55</sup> The MSCI European Index returned 22.27% YTD when denominated in local currency.

**Year-To-Date Performance: SPX, MSCI EAFE, MSCI Europe (normalized)**



Now the fundamentals: Eurozone economic activity contracted faster than in the US and UK at the end of last year and in the first quarter of 2009, as its exporters plummeted from the loss of global confidence in the wake of the collapse of Lehman Brothers. But the region appears to have recovered more quickly – in part because Eurozone consumers were less indebted and less affected by tumbling house prices.<sup>56</sup> Eurozone GDP contracted by just 0.1 per cent in the second quarter. Despite their smaller stimulus programs, their economy recovered at a greater clip because European economies generally provide greater social safety nets than those in the US. In those terms, special stimulus programs would prove redundant.

Despite signs that the economy is bottoming out, the recovery is likely to be slow and fragile. The nature of the global recovery entails substantial risks to the European economy. Because of the ongoing need for rebalancing of global demand, Europe cannot count on exports alone to drive the recovery. At the same time, the rising unemployment and credit contraction as banks continue to deleverage their balance sheets will weigh on economic activity. Bad loans tied to the recession could further aggravate tensions in the financial sector. Moreover, overhangs of foreign currency-denominated debt in emerging Europe create vulnerabilities that could resonate across the continent through the highly integrated banking system and tight trade links. Another risk is tied to consumption, which could suffer if employment adjusted only slowly to the cycle, raising the prospect of a jobless recovery, with possibly negative repercussions for confidence, consumption, and investment.

On the upside, confidence has rebounded sharply, in some cases even reaching pre-crisis levels. At the firm level, the ongoing inventory adjustment could proceed more quickly than many firms anticipate, which could prompt stronger orders than what is currently on the books. Yet, these factors may provide only temporary support for the recovery. The pickup in global trade could prove stronger and longer lasting than currently anticipated, especially if there is a stronger bounce in Asian economies given a strong export link between Europe and Asia. However, the Eurozone cannot rely on its exports to enjoy sustainable growth. For example, as of the writing of this commentary, the Eurozone reported that exports have tumbled sharply in August (-5.8%), reversing positive growth in July – so much for Green shoots.<sup>57</sup> This has given the Eurozone a severe blow as exports from rising global demand were expected to lift the EU from the economic downturn.

Beyond the short run, the recovery is likely to be hampered by the impact of the crisis on potential output and Europe's well-known structural rigidities and short-comings.<sup>58</sup> While the exact impact is hard to pin down and some of the developments affecting potential output are bound to correct themselves, others tie into long-standing European issues, such as high levels of employment protection and unrealized growth opportunities in the market for services, particularly in advanced economies.

<sup>56</sup> Europe can now boast that it is the richest region in the world, pushing North America, where wealth has declined by more than 20 percent due to the economic crisis, off the top spot. North America's wealth, measured in assets under management, plummeted by 21.8 percent, the steepest decline in the world. A lesser fall was registered in Europe, where assets shrunk by 5.8 percent compared to last year, down to €22.2 trillion – a quarter of the globe's total wealth.

<sup>57</sup> "Eurozone exports tumble sharply", *Financial Times*, Ralph Atkins, October 16, 2009.

<sup>58</sup> "Europe: Securing Recovery", *Regional Economic Outlook*, IMF, October 2009.

We would like to focus on Germany in our discussions of European recovery because of the importance of Germany as the growth engine within Europe. Recent government data indicates a German industrial revival that has encouraged hope that the country's manufacturing sector will soon be able to take over as an engine of growth from the country's "cash-for-clunkers" government incentive scheme for car purchases, which helped lift consumer spending in the first half of this year.<sup>59</sup> If Germany continued expanding at a similar pace, orders could by the end of this year be back to their level at the start of 2006. However, based on many German economists, German factory orders could fade as German exporters could still face the problems created by sluggish US growth, a weakened German banking system and the difficulties faced by economies elsewhere in the Eurozone.

***While Germany's economic prospects rest precariously on a recovery in foreign demand, there has been relatively little discussion about Germany's extraordinary export dependence. We would argue that a sustainable EU economic recovery requires a rebalancing between its surplus and deficit countries. In other words, EU surplus countries should consume more and deficit countries should consume less to rebalance the intra-EU trade and current account imbalances – the New GI Bill applied intra-Europe. Germany will need to grow under its own domestic demand while other European countries reduce their reliance on domestic demand and boost exports. Trade imbalances have narrowed during the downturn, but addressing the underlying disequilibriums will require changes in member states' economic structural rigidities despite lack of political will. If this does not happen, long-term growth in Europe will be weak and tensions within the Eurozone inevitable.***

Germany returned to growth in the second half of 2009, ahead of other European countries.<sup>60</sup> Germans were quick to rejoice that their economic model of export-driven growth was superior for both Germany but the rest of the EU. However, we believe that a reinforced German belief in the superiority of export-led growth would be a recipe for eventual weak growth in Germany and serious problems elsewhere in Europe. Germany would no doubt succeed in further boosting its market share within the Eurozone. The country's companies have shown themselves more adept at cutting costs than their competitors in other Eurozone economies. But this will come at the cost of stagnant domestic demand, similar to Chinese consumers. Against this backdrop, it will be very hard for the Eurozone's deficit countries, in particular the southern European countries, to rebalance their economies. For one thing, they cannot devalue and can only boost productivity in the long term. To boost productivity, they will therefore have no choice but to ensure that their wages and prices fall relative to those of Germany. Even if it is possible to pull this off, the impact on the Eurozone economy could be dire. Domestic demand and economic growth will be very weak, raising the prospect of fiscal crises in a number of member states.

On the other hand, if Europe was able to run a huge and steadily rising current account surplus with the rest of the world, then it could be possible for the whole of the EU to pursue a German course of export-led growth. But this is not a likely scenario. The US deficit is narrowing as American households begin the process of strengthening their finances and deleveraging as we discussed in detail above, while there is little chance of Asia assuming the role the US consumer once had as consumer of last resort.

One of the underlying problems of solving this issue is a policy divergence between France, Spain, Italy, Portugal and Greece on one side, and Germany, Finland, Austria, and the Netherlands on the other with the policy divide between France and Germany is the most damaging.<sup>61</sup> The crisis has demonstrated that political leaders treat the Eurozone not as a true economic union but merely as a single currency arrangement that is comprised of sovereign states with not much else in common. The Germans invoke the Eurozone defense when confronted with accusations of excessive current account surpluses, yet when the crisis occurred the policy response was uncoordinated and nationalistic.

On the other side of the fence is a country such as Spain. When the euro was adopted, the ECB's lending rates were below Spain's rate of inflation for many years, so Spanish households and businesses had a huge incentive to borrow which they did with a vengeance.<sup>62</sup> Spanish household debt peaked above 130% of disposable income in 2007, while consumption boomed.

<sup>59</sup> "German industrial revival gathers pace", *Financial Times*, Ralph Atkins, September 7, 2009.

<sup>60</sup> "Germany will not drive a European recovery", *Financial Times*, Simon Tilford, August 31, 2009.

<sup>61</sup> "Diverging deficits could fracture the eurozone", *Financial Times*, Wolfgang Münchau, October 4, 2009.

<sup>62</sup> "Spain's Struggles Illustrates Pitfalls of Europe's Common Currency", *Wall Street Journal*, Thomas Catan, September 14, 2009.

With a debt-fueled construction sector in overdrive, Spain was briefly propelled into being the world's ninth-largest economy. Wages rose at almost twice the rate as those in the rest of the Eurozone, making Spaniards richer. The downside was rising costs for Spanish businesses, making them lose competitiveness and productive against other countries in the Eurozone such as Germany. Once the euro turned the corner and began to appreciate, Spain is finding it tougher to export to the rest of the world. The result is an economy still contracting while others have shown signs of stabilization.

Spain's experience illustrates the difficulties of running a monetary policy for 16 countries with separate governments and widely varying economies. Exacerbating this arrangement for the euro is the large trade imbalances within the currency union. Countries like Spain, Italy and Greece have built up huge trade deficits while Germany and the Netherlands have vast surpluses. Unless both sides rebalance their economies with Germany absorbing more exports and boosting domestic demand and countries like Spain and Italy taking steps to improve competitiveness, the weakest euro-zone countries could struggle with heavy government and private-sector debts down the line.

*In summary, while Europe faces multiple problems that will require political will and major structural change within the Eurozone, we believe that there are opportunities for these developed markets to outperform the US. First, the European Central Bank will not raise rates any time soon given the fragility of the economic recovery. Second, while the strength of the euro could argueable make European goods less competitive for exports, we believe that the appreciation is still within a comfortable range where exports will not be affected greatly. We would be more concerned if the euro broke the \$1.60 mark (Plus any USD depreciation translates into higher USD returns when investing in overseas markets). Additionally, the higher euro decreases the cost of energy, and oil in particular, given that oil is priced in USD in global markets. This acts as a headwind for European companies. Third, **we believe that these markets have not experienced the multiple expansions that they deserve relative to US equity markets, especially given historical averages.** Their valuations are attractive compared to other capital markets. Moreover, their low PE ratios translates into high earnings yields compared to European corporate yields, making European equities relatively inexpensive compared to European bonds – the opposite as the US. By layering on commodity exposure and Asian exposure, we believe that the vehicle of choice for this type of exposure is the MSCI EAFE index. Again, this thesis is short-term in nature and is predicated on the continued recovery of the global recoveries. For longer term views, we clearly monitor Europe's ability to enforce a new GI Bill as it overcomes its structural issues and pursues a path of sustainable growth.*

### Emerging Markets: Asia & China

We believe that the time for emerging markets has come and the term “emerging markets” is increasingly becoming obsolete. Emerging markets represent approximately 46% of the world's output from purchasing power parity (PPP) perspective. By 2012, emerging markets will represent over 50% of global output. Their financial markets are large and liquid with volatility, corporate governance and government policies very similar to developed markets. These traditional distinctions between emerging and developed markets, once pronounced, have disappeared. The market capitalization of emerging markets has grown considerably and in total now represents 30 per cent of world market capitalization, as much as the USA. China now has a larger market cap than Japan. Korea and Taiwan, two emerging industrial powerhouses, together have a larger market cap than Germany, and Brazil has a larger market than Australia.<sup>63</sup>

***Growth is perhaps the major factor that distinguishes emerging markets from their developed brethren.*** Let's give some statistics. From 1998 to 2008, the global economy doubled in size, from \$35 trillion in total production to \$65 trillion. Economic activity in emerging markets represents \$17 billion of that \$30 billion growth as emerging markets grew 11% annually versus 5% for the global economy as in aggregate. The United States remained the largest global producer from 1998 to 2008. But by 2008, China had surpassed Japan to become the world's second largest economy, measured in PPP. The economies of China and India, which have been growing at rates approximately twice as fast as the U.S. economy over the last decade, combined to generate \$11.2 trillion of GDP in 2008, measured in PPP.

***Emerging markets should matter a great deal for all investors, now and for the rest of our investing lives. Yet today, they still represent only 12 per cent of the MSCI All Country World Index, while representing 30 per cent of the world's market capitalization, 50 per***

<sup>63</sup> “Emerging market label is obsolete”, *Financial Times*, Marko Dimitrievic, September 28, 2009.

**cent of the world's economy, and the world's best growth prospects. Investors focusing on benchmarks will miss this opportunity. The end of the term "emerging markets" is here. Investors that don't catch on to this reality risk being left behind.**

As the economies and trade surpluses of emerging market nations have grown, so have the foreign reserves held by emerging markets. Over the past decade, China, Taiwan and Korea have emerged as major net buyers of U.S. debt. In fact, by 2008, more than 63% of global foreign reserves were held by emerging markets nations, up from 38% just 10 years earlier. Trade surpluses, accumulated foreign reserves, and the conversion of debt from hard currency (U.S. dollar or euro-denominated) to local currency all have helped to improve the balance sheets of emerging market sovereigns. A decade ago, just 3% of the emerging debt universe was investment grade. By 2009, more than 40% of emerging market debt was investment grade. And in 2008, after a decade of battling inflation, Brazil saw its debt raised to "investment grade" status by Standard & Poor's followed in 2009 by Moody's rating agency.

What about decoupling from the developed world? We conclude that emerging markets were insulated from the initial financial shock to US and European financial markets but were not insulated from the real effects of a downturn in economic activity or the post Lehman collapse of credit markets which affected emerging market exports, trade financing, capital flows and foreign direct investment. Emerging market asset prices were largely insulated or decoupled from the crisis for some months, but then fell even harder than prices for US assets as expectations about GDP growth in the United States and other industrial countries deteriorated in the summer of 2008. Finally, the Lehman bankruptcy in September 2008 generated a very direct financial shock to emerging markets as trade credit evaporated and international trade declined sharply and uniformly around the world.

**Therefore, while global output of emerging economies will continue to grow at the expense of the developed world, they are not yet in a position to act as a powerful locomotive for industrial countries through their domestic consumption programs.** We believe this the case because part of the growth is based on temporary factors, including a huge stimulus in China. Moreover, like their industrial country counterparts, governments will come under more pressure to implement exit strategies to their stimulus policies. As investors, we are looking for emerging economies to pursue sustainable domestic consumption patterns with an accelerated shift in policy emphasis from the producer to the consumer. Milestones include more aggressive measures to strengthen social safety nets and greater exchange rate flexibility.

According to projections from Credit Suisse, the percentage share of global consumption of the US will decline from 30.2% in 2007 to 20.8% by 2020. In sharp contrast, the share of Chinese consumption is projected to improve from a mere 5.3% of global consumption in 2007 to 21.1% by 2020. India's consumption, which was 2% of global consumption in 2007, is forecast to rise to 5.3% by 2020. By 2020, according to the Credit Suisse forecasts, China will be the largest contributor to global consumption and India will be the fourth largest. This change in the global economy is likely to be hastened by the current crisis, which is expected to keep growth rates low in the West for years, as their economies deleverage, resulting in the "New Normal".<sup>64</sup> Many of the systematically important emerging markets share some important characteristics in the New Normal, namely low labor costs, extremely low levels of consumer debt, and large relatively young populations.

<sup>64</sup> "The Global Shift in Market Capitalization", *Market to Market*, Mana Chakravarty.

### Global Share of Consumption

(% share of global consumption)	2007E	2008F	2009F	2010F	2015F	2020F
U.S.	30.2	29.3	28.3	27.4	23.5	20.8
Non-Japan Asia	12.1	13.6	15.5	17.1	25.8	32.3
China	5.3	6.4	8.0	9.3	16.4	21.1
Japan	8.2	7.9	7.7	7.4	6.5	5.8
Germany	5.6	5.5	5.3	5.1	4.3	3.8
U.K.	5.0	4.9	4.8	4.6	4.0	3.7
France	4.2	4.1	3.9	3.8	3.2	2.9
Italy	3.6	3.4	3.3	3.2	2.7	2.3
NIE 4*	2.9	3.0	3.0	3.0	3.1	3.1
India	2.0	2.2	2.4	2.6	3.9	5.3
Spain	2.4	2.3	2.2	2.2	1.9	1.8
ASEAN 4**	1.8	2.0	2.1	2.1	2.5	2.7
Canada	2.3	2.3	2.2	2.1	1.9	1.7

Source: Credit Suisse

#### Asian Markets

The emerging Asian economies have bounced back far more sharply than the developed economies. Fundamentals are now in better shape in these economies, with fiscal balances far healthier than in Western economies. Their banking systems, stuffed with liquidity, appear ready to fuel another round of solid expansion. The four emerging Asian economies which have reported GDP figures for the second quarter (China, Indonesia, South Korea and Singapore) grew by an average annualized rate of more than 10%. In fact, emerging Asia should grow by more than 5% this year at a time when the old G7 could contract by 3.5%.<sup>65</sup>

This is but partial evidence that Western politicians should brace themselves for more talk of economic power drifting inexorably to the East. The economic center of gravity has been shifting for some time but this recession has marked a tectonic turning point. Western economies are increasingly depending on emerging Asia to lift the world, rather than the US, and that's never happened before. How has Asia made such an astonishing rebound?

Asia's rebound has several causes. First, manufacturing accounts for a big part of several local economies, and industries such as cars and electronics are highly cyclical. Output drops sharply in a downturn and then explodes in the upturn. Second, the region's decline in exports in late 2008 was exacerbated by the freezing up of global trade finance, which is now flowing again. Third, central banks quickly shifted towards an easing of monetary policy. Fourth, public demand for the whole region has contributed about half of the regions GDP growth in the first half of 2009, more than offsetting the drag in exports. Fifth and most important, **domestic spending has bounced back** (at least for the time being) because the fiscal stimulus in the region was bigger and worked faster than in the Western economies as consumer confidence recovers, retail sales have picked up and business confidence is improving. Household spending growth in Asia is estimated at \$170bn this year, offsetting the plunge in spending in the US Investment. India aside, the Asians entered this downturn with far healthier government finances than developed countries, allowing them to spend more money. Low private-sector debt made households and firms more likely to spend government handouts and Asian banks were also in better shape than their Western counterparts and able to lend more. Asia's prudence during the past decade did not allow it to escape the global recession, but it did cushion the fall and made the region's fiscal and monetary weapons more effective.<sup>66</sup>

However, it is easy to boost an economy with lots of government spending and running of the printing presses. But Asian policymakers now face several difficult problems. Their immediate

<sup>65</sup> The global economy is expected to contract by -1.1% in 2009 with an expected growth of 3% in 2010 based on IMF estimates.

<sup>66</sup> "An astonishing rebound", *The Economist*, August 13, 2009.

dilemma is how to sustain recovery without inflating credit and asset-price bubbles. Monumental amounts of liquidity and low interest rates are fuelling a boom in property and capital markets that may grow to unmanageable proportions. Local equity and property markets have begun showing signs of bubble formation. Eventually, such bubbles will burst, along with the potential of sustainable growth, and any notion of decoupling along with it.

Therefore, these cycles need to be tamed. As growth decouples from western economies, monetary policy should be tailored more and more to address local growth conditions versus using it as a tool to manage foreign exchange rates.<sup>67</sup> The ongoing intervention in foreign exchange markets only impedes this process. What Asia requires, in short, is monetary policy decoupling from the Fed where it allows its central banks greater exchange rate flexibility. But, as we discussed earlier, policymakers' pursuit of export-led growth and their reluctance to let their currencies rise faster against the dollar means that they have outsourced their monetary policy to America's Federal Reserve, and is therefore too lax for these perkier economies. The longer-term challenge is that once the impact of governments' fiscal stimulus fades, growth will slow unless economic reforms are put in place to bolster private domestic consumer spending. This is a mistake that Japan is still paying.

Because of these challenges, most of the current drivers of growth in Asia are set to wane and potentially disappear very soon. The turn in the inventory cycle in the U.S. and Europe should continue to provide a boost to the region in the coming months but this will gradually lose strength. We expect the process of restocking and inventory rebuilding to have largely run its course by the first to second quarter of next year. Similarly, many countries in the region, directly or indirectly, have benefited from incentive programs, i.e. cash-for-clunkers, in the U.S. and Europe directed at stimulating purchases of new automobiles. As these programs run their course, global demand for autos and related inputs may dissipate, perhaps sharply if it transpires that these programs have done no more than change the timing of purchase decisions, which we believe is the case.<sup>68</sup> Any weakness from the developed countries can suppress growth rates despite the initiatives Asian economies have made during the past decade to distance and cushion themselves from the West. ***We believe Asia will not be able to count on strong external demand for some time to come.***

As a result, ***the impetus for Asia will need to come from within and policymakers will have to carefully manage the transition from public-led to private-sector led, domestic demand growth.*** The region will need to seek out the means to activate the private, domestic drivers of activity that are not yet in place. Efforts should therefore be directed at strengthening consumer confidence and facilitating a pick-up in private investment, particularly in those industries geared toward domestic markets rather than export markets and manufacturing capacity. At the same time, Asia will need to continue to improve productivity. The fundamental shift in the drivers of demand—from the manufacturing of exports toward domestic sources and services—has the potential to lower productivity and employment, at least over the near-term.<sup>69</sup> It will be essential to offset this depressing effect on growth through financial development, improvements in corporate incentives, and more efficient ways to allocate both capital and labor.

***In summary, by reducing their dependence on exports, boosting domestic buying power and improving domestic investment opportunities, Asian countries can assume a greater and arguably rightful role in the global economy. Asia will always have its export hubs, such as Hong Kong and Singapore but the largest countries, China and India, have vast interior areas that are largely unaffected by the export economy and where some of the greatest growth can occur, producing a new growth model based on domestic commerce and consumption. By dampening growth in the West and compelling Asian countries to look inward for growth, the recent global economic upheaval may well prove to be the catalyst that accelerates the transition to the new global economic order of the "New Normal."***

### China

***Although the global economic crisis is far from over, China has been able to engineer a resumption to growth patterns in May of 2009 with very vigorous responses through a unique mixture of Keynesian policies and governments planning.*** This has resulted in significant domestic growth while the rest of the world contracts. In the second quarter, its official figures showed year-on-year gross domestic product growth of 7.9%. This is partially evidenced

<sup>67</sup> "Emerging Asia must heed the risks of bubbles", *Financial Times*, Frederic Neumann, August 2, 2009.

<sup>68</sup> "Asia & Pacific Region – Outlook and Challenges", Anoop Singh, IMF, Istanbul, October 4, 2009.

<sup>69</sup> "Asia & Pacific Region – Outlook and Challenges", Anoop Singh, IMF, Istanbul, October 4, 2009.

by the fact that electricity production in June increased 5.2 per cent, reversing the falls of the previous eight months.<sup>70</sup> It is almost certain that China's GDP will grow more than 8 per cent this year. Additionally, China's manufacturing expanded in July at its fastest rate in a year as domestic demand offset sluggish exports highlighting the importance of Beijing's huge stimulus in driving Chinese growth. Manufacturing activity continues to accelerate as orders growth is being driven more by the domestic economy.

At the same time, the country has passed a important economic milestones this year. It is now the world's largest exporter, surpassing Germany. It is the world's largest market for vehicles, surpassing the US. Its foreign reserves, the world's largest, are now over \$2,000bn, making it the world biggest creditor country. The biggest milestone – the moment when China becomes the world's largest economy – is getting closer. Goldman Sachs predicted a couple of years ago that China would hit that target in 2027, before the financial crisis. If the US is now set for a long period of slower growth, the big moment could come rather sooner.<sup>71</sup>

That said, China has been able to build the most powerful growth machine during the past three decades the world has ever seen as it has taken unprecedented numbers of people out of poverty and has urbanized them. This has been due in large part to the government emphasis on policy actions that benefit domestic investment and the export sector which has worked incredibly well thus far. These same policies that emphasize export growth unfortunately have de-emphasized domestic consumption. However, as many economists with which we agree, the same policies that produced this growth miracle are clearly unsustainable as they have created these global imbalances which by their nature are very destabilizing. The trade surplus, which accelerated in 2001 as China entered the World Trade Organization, opened up in 2004, and peaked in 2007 at 8% of Chinese GDP.

**Despite all this good news, there are reasons for caution.** Let's first focus on China's stimulus initiatives. China's decision to employee government spending to jumpstart demand was one of the strongest Keynesian of all national responses to the economic crisis and perhaps the largest on record for both developed and developing economies. The most prominent part was the central government's investment initiative. The initial program, announced in November of 2008, was for 4 trillion RMB, or 13% of China's GDP, with disbursements starting immediately.<sup>72</sup> This resulted in government investment impacted the economy during the first quarter of 2009.

In addition to the direct government stimulus program, a flood of lending from Chinese state-run banks financed another less-publicized stimulus initiative. The same directive that urged huge government investment also instructed state-owned banks to step up their lending to government approved projects. As a result, banks lent over 7.4 trillion RMB, or 24% of GDP, during the first half of 2009. **Many economists now contribute over 14% of Chinese GDP during the first half of 2009 to be a direct result of this credit expansion.**<sup>73</sup> Why such a massive credit expansion? Because it was necessary to finance the rapid rollout of investment projects initiated by local governments that did not have the money to pay for them. And these loans mostly went to state-run companies that enjoy the explicit guarantee of these loans.

**More importantly, while the Chinese stimulus has had a big impact on the economy that still remains a planned economy, its ability to mobilize resources in an efficient manner to the best uses are always at issue.** In fact, just recently, the Chinese government issued a warning about the risk from rising overcapacity in the economy, saying it could hamper recovery and lead to a surge in non-performing bank loans.<sup>74</sup> In fact, Chinese regulators are now concerned that too much money is being lent by the state-controlled banks and the country's tentative economic rebound could come at the cost of a stable financial system. In statements published last week, Wu Xiaoling, who recently retired as deputy governor of the central bank, warned new lending this year would probably reach as high as 12 trillion RMB, a staggering increase of 40 per cent of the entire stock of outstanding loans in just one year. To add injury to insult, government officials are also concerned that continued expansion of heavy industry such as aluminum and cement, which use a lot of power, will complicate efforts to meet energy efficiency targets. **It is difficult for a country that has expanded its loan base by 34% in one year without massive inefficiencies and asset speculation in its wake. Only 5% of this**

<sup>70</sup> "China's stimulus shows the problem of success", *Financial Times*, Yu Yongding, August 25, 2009.

<sup>71</sup> "China makes gains in its bid to be top dog", *Financial Times*, Gideon Rachman, September 14, 2009.

<sup>72</sup> "In China's Economy, the State's Hand Grows Heavier", *Current History*, Barry Naughton, September 2009.

<sup>73</sup> "In China's Economy, the State's Hand Grows Heavier", *Current History*, Barry Naughton, September 2009.

<sup>74</sup> "China warns banks over asset bubbles", *Financial Times*, Jamil Anderlini, July 27, 2009.

**year's loans went to private enterprises (which employ 75% of the urban workforce) while 95% went to state-owned enterprises.**

What is the downside to these initiatives? **Because this flood of money is so much larger than the economy's basic needs given lower growth and zero inflation, inevitably this liquidity will wind up into speculative investments creating asset bubbles.** These loans have been used to increase manufacturing capacity and other forms of capital formation to generate GDP and job growth. China's economy has rebounded sharply in recent months due to an investment boom – much into infrastructure – fuelled by increased public spending and a surge in lending by the state-owned banks. In a world already suffering from a capacity glut, this is a highly deflationary development. Cases of poorly designed and dangerous construction projects have already surfaced. Due to the hasty and under-supervised implementation, waste in infrastructure construction is ubiquitous, and the prospective returns of this big push into infrastructure are less than promising. The government will have to pay for the long-run implications of failed projects and associated increases in nonperforming loans on bank balance sheets.

Even the stock market began discounting in potential bubble formations as it experienced a significant correction in July of 2009 while other stock markets continued their climb.



Why did the Chinese government decide to take this path? *To maintain decent growth and avoid massive unemployment, the Chinese government was left with no option but to replace plummeting external demand through their export sector by domestic demand. Because it is difficult to stimulate domestic consumption in the short run, investment demand became the only viable alternative.* As a result of the stimulus package, the growth rate of fixed asset investment hit 36 per cent year-on-year in the first half of 2009, and China's investment rate may have surpassed 50 per cent of GDP with the share of the economy devoted to fixed investment soaring above 45% in 2009.<sup>75</sup> The rush to invest will inevitably be accompanied by some erosion in the quality of growth and return of capital.

*What will it take to bring China on a path to sustainable growth? China needs to develop its own GI Bill – for China to be more prosperous in the longer run its economy will have to adjust whereby domestic consumption and services grow rapidly while the growth of investment, heavy industrial output and manufacturing capacity slows dramatically. More resources should be used in building a decent social safety network, so household consumption can play a more important role in driving economic growth. Government spending should be conducive to private investment and help the development of small and medium-sized enterprises. To achieve a sustainable rebound, China needs to strike a fine balance between crisis management and structural reforms.*

<sup>75</sup> "China's stimulus shows signs the problems of success", *Financial Times*, Yu Yongding, August 25, 2009.

*If China fails to tackle its structural problems, including its export dependency, high investment rate and wide income gaps, growth is unlikely to be sustainable.*

Private consumption is running at about 36 percent of GDP in China right now. That is half of the US consumption rate, and it's about two-thirds of the consumption rate of Europe. It has come down very dramatically in the last decade where it reached approximately 50% of GDP, and tested levels that we've really never seen in any other major economy in the history of the modern global marketplace. This will only happen as domestic consumers gain confidence in the social safety nets of the Chinese government and the recovery of the remaining global economy. With clean balance sheets and further urbanization of the Chinese population, the Chinese consumers can be well-positioned for a secular rise. That said, China's rebalancing will require more policy initiative. China could do more to eliminate both internal and external price distortions to reduce its dependency on external markets such as let its currency float. While China's crisis management has succeeded in reviving growth, its achievements in structural adjustment are mixed.

China today is mainly viewed by multinational corporations as offshore production platforms – outsourcing of cheap labor and manufacturing. Going forward, there will be a growing opportunity set to profit by tapping into the 3.5 billion of Chinese consumers. At the same time, the current export-driven development strategy is now in trouble and their options in terms of economic development have narrowed like never before. Most Asian countries have increased integration in the Chinese supply chain by becoming big exporters to China. Therefore the central premise to a renewed and **sustained** growth policy for the Asian region will require a rise of internal demand sourced by Asian producers. Such a sustainable policy will require bringing the Asian consumer into the equation in a big way and will require Asian producers focusing on home markets rather than just to foreign markets.

***In conclusion, China is on track to achieve significant growth in 2009 with investment growing robustly through massive stimulus initiatives. At the same time, the long term consequences of China's programs are far from clear. Though the benefits are manifest, some economists wonder whether China is laying the appropriate groundwork for sustainable growth or just increasing its export capacity despite deleveraging on the part of Western consumers. The short-term rebalancing of thus far via a huge credit expansion and surge in fixed investment, is a temporary band-aid. It must lead to a rebalancing of the Chinese economy towards domestic consumption. This is in China's interests and it is also in the interests of a better balanced world economy. The main idea now is how to create consumption for all these new consumers from China, India, and other countries as Western consumers drop off given our resource constraints and given our environmental constraints. If emerging market economies do not rebalance and if the consumer in the US, UK and Europe do not come back, what do we do next? While there are many reasons to be excited about China and its prospects in the future, there are reasons to be concerned and cautious in deploying investment capital in those markets.***

## Select Topics

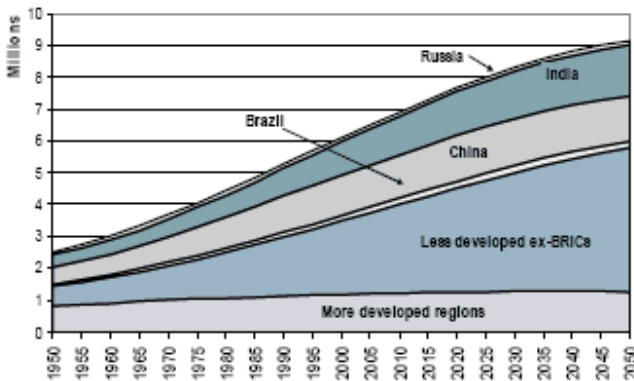
### Commodities

After collapsing during the second half of 2008, commodity prices broadly stabilized in early 2009 and subsequently staged a strong rally in the second quarter, despite generally high inventories that resulted from the weak demand through the recession. *A rally this strong at such an early stage in the recovery of global industrial production contrasts with past experience because commodities are considered late-stage cyclicals – they rally later in the business cycle as inventories fall, supply becomes very constricted and demand increases. Similarly, during this sell-off, what was very unique from a technical perspective was the fact virtually all the commodities bottomed at higher prices than during other recessions in the past. This held true for oil, industrial commodities and soft commodities.* In fact, the broad-based CRB Index below depicts our recent higher low:

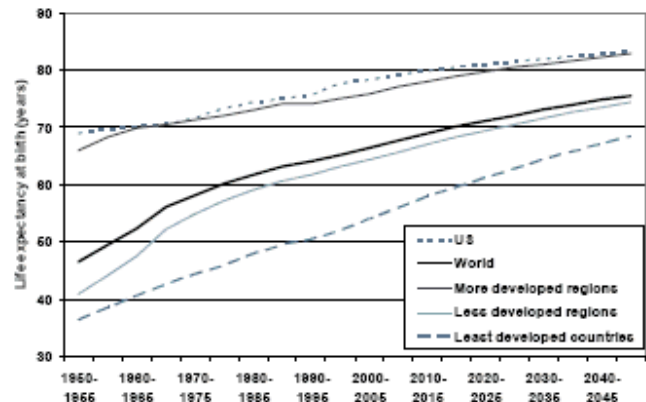


That said, let's begin our discussion of commodities by addressing **demand**. The recent loss in commodity demand was proportional with the loss in economic activity as a result of the economic downturn which suggests that as the economy recovers, so will strong commodity demand. Industrialization, globalization and westernization of the past 50 years have caused the rise of rest – emerging market countries – whose implications to the global natural resource supply and environment we are just beginning to realize.<sup>76</sup> The world's population is expected to grow from 6.8 billion currently to 9 billion in 2050, according to the United Nations. The agency estimates that virtually all of the growth will be from the developing world that continues to urbanize its population, requiring more and more commodities per capita as a result.

**Global Population Growth**  
Source: Goldman Sachs Research



**Global Life Expectancy Statistics**



The perception of an improving near-term economic outlook has affected physical commodity markets primarily by increasing the incentive to hold inventories before price increases and as an alternative to holding dollar-denominated assets. At the same time, improving financial conditions have provided for increased credit availability for inventory financing at low costs. In addition to the fundamentals, the variation in price changes reflects not only differences in cyclical sensitivity of different commodities but also reflects commodity-specific factors. For example, prices in oil markets were supported not only by recovery expectations, but also by Organization of Petroleum Exporting Countries (OPEC) supply cuts, while metal prices have been buoyed by restocking in China, given the ease in which they could be transported and stockpiled. In sum, commodity demand prospects now depend increasingly on growth in emerging and developing economies, given the steady rise in their market shares as noted above.

Moreover, commodity demand in these economies is more income-elastic than in advanced economies. With a recovery already under way in emerging Asia and the recovery in emerging economies generally advancing well ahead of advanced economies, commodity demand is strengthening despite negative activity in advanced economies. Commodity prices, especially in cyclically sensitive sectors, have responded strongly to news about an earlier than-expected

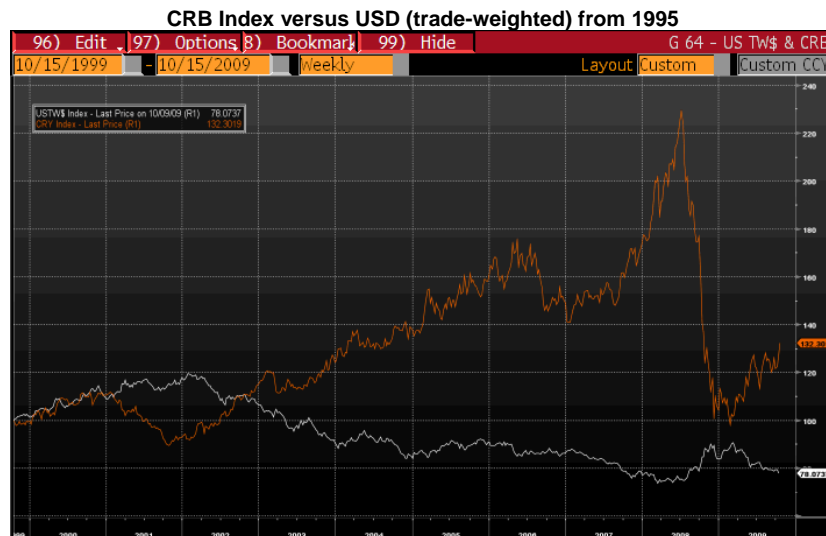
<sup>76</sup> "Commodities in Crosshairs – a commodity shortage lies ahead", Goldman Sachs Research Roundtable, August 5, 2009.

recovery under way in emerging Asia in the second quarter of 2009. **The extent and magnitude of further upward price pressure will largely depend on the timing and strength of the global recovery in the shorter term.**

**However, we believe that commodities have become overly anticipatory in the short term.** With inventories remaining above average except for food commodities and with substantial spare capacity in many commodity sectors, such pressure is likely to remain moderate for some time, unless stronger-than expected global growth leads to a rapid drawdown of these inventories.<sup>77</sup> There are also near-term risks that the largely expectation-driven price rebound could be partially reversed if the global recovery is more sluggish than currently expected in commodity markets. **Therefore, if we see the global recovery showing signs of sputtering, we would expect sharp corrections in the commodity space given the lofty good news already built into the prices in the shorter term.**

**Over the longer term, as we have previously emphasized, the secular bull market in commodities is a supply story due to decades of suboptimal investment.** This problem has been exacerbated over the past year by the sharp drop in prices which dis-incentivized producers and tight credit conditions as a result of the financial crisis. The sharp price drops were caused by the severity of the financial crisis which did not allow commodity prices to remain high enough to spur much needed supply. The huge price swings that resulted from the collapse prevented many projects from coming online. Global imbalances also worsened the commodity supply outlook owing to the sharp price drop and tight credit conditions that resulted from imbalances. Decades of poor returns in oil, gas, metals and mining industries caused capital to be redirect to technology-oriented industries, i.e. the “New Economy.”<sup>78</sup> This starved the commodity infrastructure of much needed capital to expand capacity.

**Commodity prices also depend on USD developments. Historically, there has been a generally negative correlation between commodity prices and the effective USD exchange rate (trade-weighted basis) in the tune of a -47% correlation.** This negative correlation is consistent with incentives to hold commodity inventories to hedge against dollar fluctuations (especially with global central banks) in the short term, with the dollar’s effect on relative purchasing power becoming more important over the longer term. **Lastly, to the extent that inflation is a source of concern and the source of inflation stems from commodities, owning a basket of commodities will provide an excellent inflation hedge. The Goldman Sachs Commodity Total Return Index gained 4.0% in real terms over our Decade of Inflation from 1973 to 1982.**<sup>79</sup>



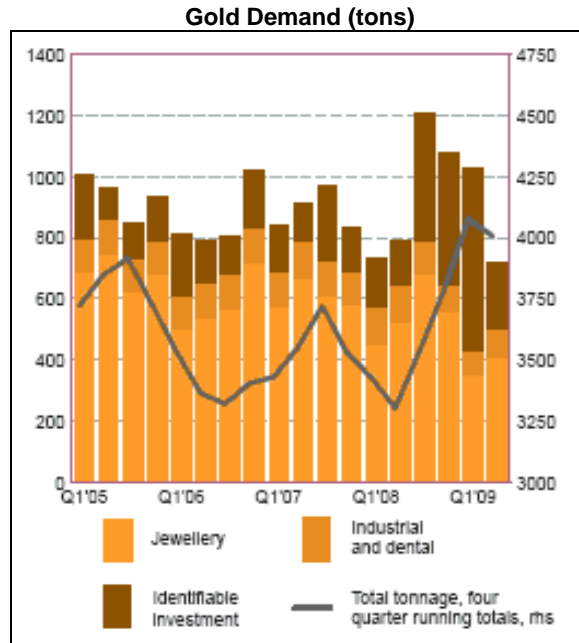
<sup>77</sup> “Sustaining the Recovery”, World Economic Outlook, IMF, October 2009.

<sup>78</sup> “Commodities in Crosshairs – a commodity shortage lies ahead”, Goldman Sachs Research Roundtable, August 5, 2009

<sup>79</sup> “Everything You Wanted to Know About Inflation but Were Afraid to Ask”, CTC Consulting, August 2009.

**Gold**

To single out one commodity in particular, at the present moment, gold is perhaps the most favored and talked about investment. We feel that it falls into an asset class that is very hard to value intrinsically. Many factors move the price of gold. They range from fundamental drivers such as jewelry demand to external dynamics such as Black Swan events to haven buying and currency movements. Depending on the economic climate and market expectations, different factors will drive gold prices in different ways.



Source: GFMS

Based on empirical evidence, gold as an investment has not had a great risk and return profile. From 1915 through 2008, gold has had an annualized real return of +0.79%.<sup>80</sup> If we add in the cost of storage and insurance, the return is eroded further. During that same time period, gold has experienced the same volatility as equities which translate into experiencing equity-like volatility with cash-like returns. So why the interest in gold? Let's go over some of the traditional reasons why investors buy gold for investment purposes.

The First reason is as an inflation hedge. There have been many studies investigating the relationship between gold prices and inflation upon the view that gold will return to its long run purchasing power. However gold has not proven to be an effective hedge against inflation in the short term. In fact, the price of gold went from \$400 to \$1060 while CPI went from 3.7% YoY to 1.5% YoY from 2001 through 2009. However, during the previous two decades, as CPI increased, the price of gold moved side-ways. **Therefore, although gold tends to act as an effective inflation hedge over a prolonged period of time it will not necessarily provide a hedge for short periods - it needs to be managed tactfully as a hedge. In other words, as gold always tends to return, or mean revert, to its long run purchasing power, the timing is not always consistent and may require a number of years or even decades to do so.**

However, our thesis on holding gold is to express our short USD thesis and as a protection mechanism during periods of hyper-inflation. Empirical evidence has shown that during periods of hyper-inflation – usually caused by protracted periods of expansionary monetary policy – gold has outperformed. For example, over the ten year period from 1973 to 1982, inflation annualized at 8.7% and gold turned in an impressive 12.7% real rate of return per year over that time period.

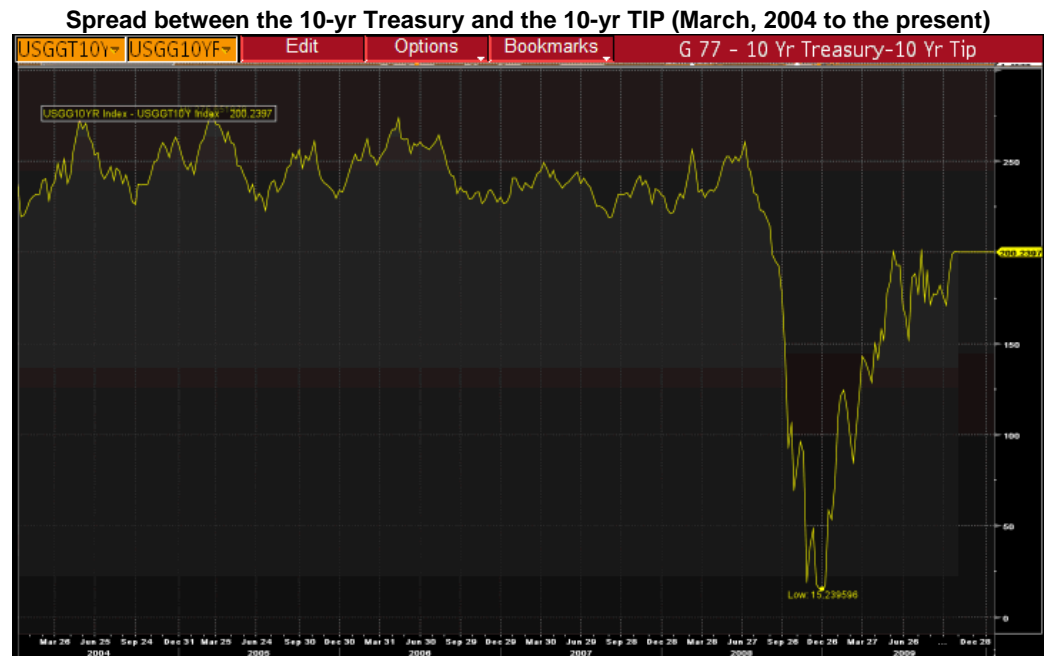
Because gold has performed well during periods of high inflation and because of its perceived role as an insurance policy during periods of economic calamity, its demand has been on the rise

<sup>80</sup> "Everything You Wanted to Know About Inflation but Were Afraid to Ask", CTC Consulting, August 2009.

as global central banks have been running the printing presses at unprecedented rates. Moreover, monetary policies have lowered short term borrowing costs to such a point that borrowing at near 0.0% costs and buying gold as long-term call options has become a popular trade. Diversification away from the USD by global investors such as central banks and sovereign wealth funds has brought in many cross-over purchasers, making gold a popular trade. Since we are on the topic of inflation.....

**Inflation versus Deflation Debate**

Currently, the inflation outlook is very benign with core inflation continuing to slow. This is in a backdrop of global policy interest rates remaining at unusually low levels. Global growth has fallen from 3.0% in 2008 to -0.8% in 2009 representing the first decline in the world economy since the IMF began collecting the data in 1970. September government data has US producer prices declining by -0.6% on a month-over-month basis while the consensus was looking for flat prints. Even the core CPI (excluding energy and food) was down -0.1% MoM. From a bond market aspect, yields are back to pre-crisis low levels and the 'breakeven' level on 10-year TIPS securities, at 196bps, are fully 74bps below the average of the past decade.

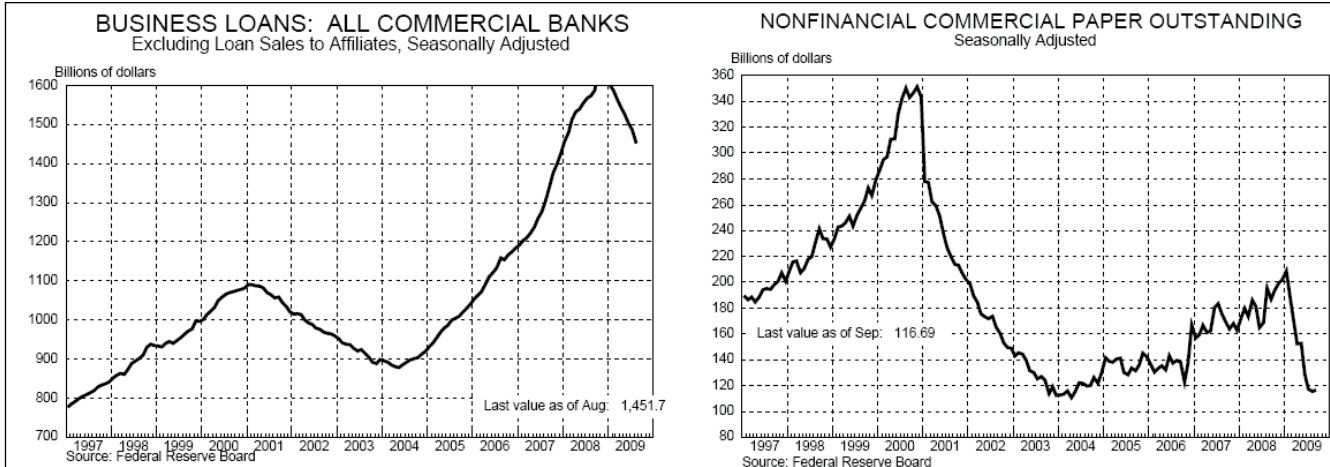


This has occurred despite the slump in the USD and a rise in commodity prices. Additionally, core consumer goods producer price index fell -0.1% MoM. In fact, upon close analysis of third quarter earnings releases reveals that companies such as Wal-Mart, Johnson & Johnson, Proctor & Gamble and even Coca Cola have had to reduce prices and cut costs as a result of lack of top-line growth. The only sector that has had **any** pricing power has been pharmaceuticals. Ironically enough, we don't know how long this will last given the Obama administration's sweeping healthcare reforms on the cost of healthcare, and the cost of prescription drugs in particular.

Our discussion of inflation begins by analyzing the various sources and measures of inflation to predict if there are any signs of inflation coming on the horizon. These include economic factors such as employment and wages, capacity utilization, rents and credit conditions - commonly called demand-push and cost-push inflation, as well as monetary policies. On the one hand, high unemployment rates and slack capacity utilization (resource gaps) are often associated with falling inflation. On the other, large, sustained and explosive growth in money is associated with high and variable rates of inflation. The logic and evidence are overwhelming. Economies that are running the printing presses for extended periods of time, usually to finance unsustainable fiscal deficits, generate great instability in prices and high inflation. Moreover, in trying to assess inflation risk from monetary conditions and resource slack, we must remember that these factors are strong predictors only in relatively extreme cases. **Because we currently find ourselves in a situation with competing extreme cases of both large resource gaps and big expansions in the monetary base, we find ourselves in the Great Inflation or Deflation Debate.**

**Economic Activity**

The interest rate sectors of the economy continue to show signs of financial distress. Consumer credit continues to contract despite unprecedented policy initiatives. Mortgage activity remains very tame as low rates fail to entice new mortgage applications or refinancing activity. On the corporate side, US corporate commercial paper outstanding remains at multi-year lows and is not expanding much to help finance accounts receivables. At the same time, business loans are still on a protracted downtrend.



With credit conditions down, we also find ourselves with enormous US and global manufacturing capacity and labor market slack. **Despite a recent pop of its lows, US capacity utilization is sitting at multi-decade lows. This excess capacity must be used before inflation risk will emerge which means that the US and global economy must embark on a prolonged period of economic expansion.** In summary, as resource gaps remain very substantial today, that acts as an enormous mitigant against inflation pressures through the mechanism of labor markets.



**Employment & Wages**

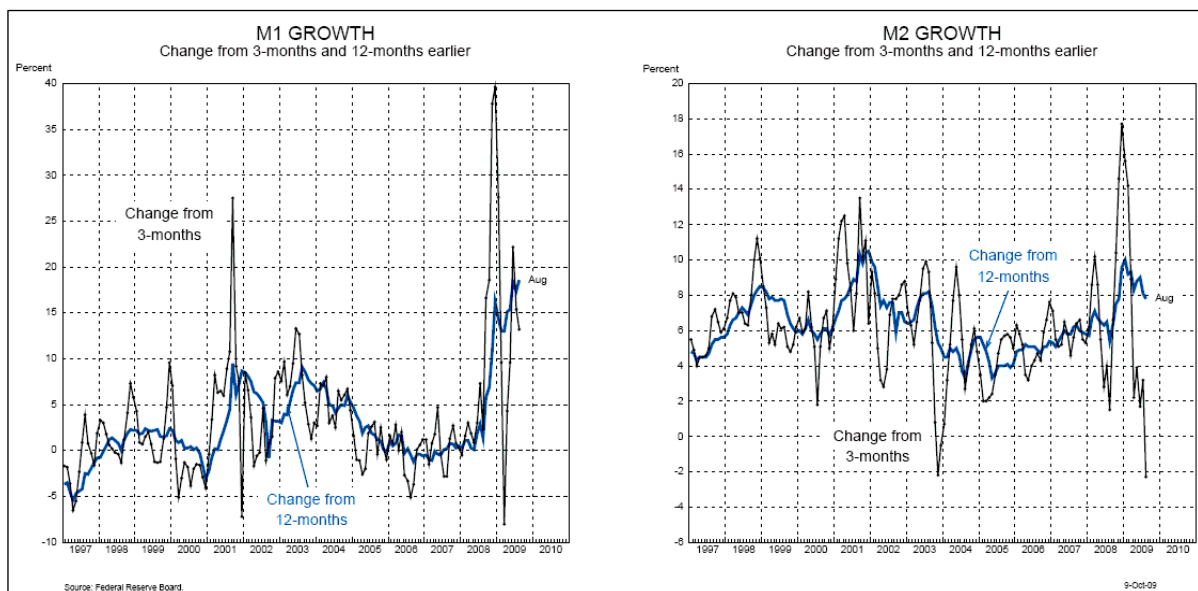
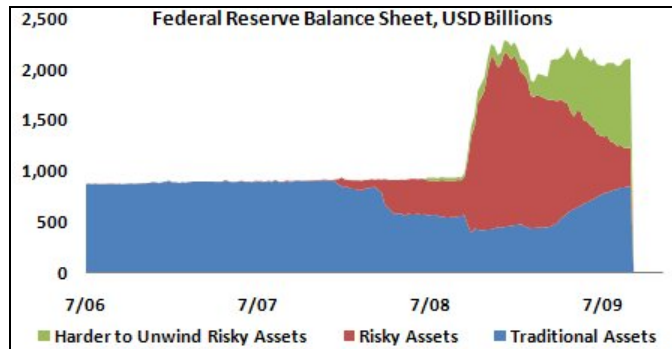
There has never been a sustained inflationary period without wage inflation. Labor costs account for as much as 70% to 80% of total costs of production in the US which means that there cannot be prolonged periods of inflation without accelerating wages. And labor cannot negotiate higher prices when unemployment is so high and there is an excess supply of labor relative to demand. As we discussed above, the low utilization of the US manufacturing capacity and the slack in the US economy heavily depresses labor demand and real wages and with organized labor representing an ever smaller share of the US workforce, the outlook is bleak. Let us try to quantify the weak wage effects in terms of years.

**As we mentioned previously, the economy is now operating at a level that is more than ~ 10 million jobs short of full-employment not to mention the 100,000 new jobs per month needed to keep up with population growth. If we assume that the US economy will begin generating new jobs at the same torrid pace during the 1990s at 2.1 million jobs per year, we believe it could be 2017, if not longer, before employment reaches 5.0% and sustained inflation emerges.**<sup>81</sup> And this scenario assumes trend growth for the US economy – an assumption not consistent with the New Normal. Indeed, others such as HIS Global Insight does not see pre-recession 5.0% unemployment rates anywhere in its 10 year forecast which now is penned at 5.75% in 2019. **Therefore, from a real wage perspective, inflation should remain tame for a very long period of time, pending unexpected initiatives aimed at bypassing free markets and increasing wages legislatively.**

**Monetary & Fiscal Policy Concerns: Inflation and Expected Inflation**

Despite a 0.0% Fed funds rate, a record 13% fiscal deficit/GDP ratio, and a \$2 trillion Fed balance sheet, inflation and inflation expectations remain well subdued. Let’s try to see why this is the case and how long it will last.

Over the last two years, the Fed has taken extraordinary actions with monetary policy, both through traditional rate cuts and an unprecedented expansion of the Fed balance sheet. **We all focus at the Fed’s bloated balance sheet but the problem is that the reserves the central bank has created are sitting as cash on banking sector balance sheets and not being re-circulated into net new credit creation which suggests that velocity is still contracting. Not only is velocity contracting, but so are the broad monetary aggregates.**



Source: Federal Reserve Board, Council on foreign Relations

<sup>81</sup> "It Will Be Years Before Lost Jobs Return – and Many Never Will", *Wall Street Journal*, Sudeep Reddy, October 5, 2009.

Under normal circumstances, an increase in the monetary base results in an increase in broad money, because banks generally lend out almost all of their excess reserves to produce gap income. But if they choose not to do so in order to raise excess reserves, broad money will not increase as fast as the monetary base and the likelihood of a rise in inflation is greatly diminished. An example of this occurred during the early part of the Great Depression, when base money grew significantly but the broad money stock actually fell by one-third.<sup>82</sup> We also find ourselves in the same predicament today between the monetary base and broad money. Over the past year, monetary base has nearly doubled as the Fed has rapidly expanded its balance sheet. However, given the sluggish growth in bank credit, broader money has risen much less, by only around 8 percent. **So we'll need to see much more expansive bank lending if the monetary base expansion is to trigger an inflation response. And we've yet to see this happen in the current economic downturn.**

**On the flip side, the period in the U.S. from 1965 to 1982 provides a good example of how a long, sustained increase in money growth tends to increase both contemporaneous inflation and expectations of future inflation.** Over this period, the price level more than tripled, with the inflation rate peaking at over 11 percent in 1980. This rise in the price level was accompanied by strong growth in both narrow and broad monetary aggregates. The monetary base, like the price level, more than tripled over this period, and M-2, which is a broader measure of transaction money, more than quadrupled. Increased bank lending was a key factor in broad money growth.

*During the current period, inflation expectations have remained well-contained. Higher money growth today, however, may lead people to conclude that inflation will increase in the future. Unchecked fiscal imbalances can also lead to higher expected inflation if the public believes that at least some of the fiscal deficit will be paid by printing money. And inflation expectations can increase if everyone believes that a central bank will refrain from increasing policy rates, for political reasons, even in the face of inflationary pressures. For this reason, let's turn to the relationship between central bank independence, fiscal policy and inflation outcomes. Independence of the central bank is always important in the setting of inflation expectations. Periodically, the central bank must take tough actions that are needed for future and medium-term prosperity, even though these actions are painful in the immediate short term. Fiscal pressures can also pose problems for central bank independence, if large deficits are expected into the foreseeable future. Even if the central bank pursues a tight monetary policy, both current and expected future inflation can still increase if the public believes that the central bank will be forced to monetize the government debt sometime in the future. In principle, very large debt levels could compromise the independence of even the strongest central bank, if the choice is between monetizing the debt and inducing a costly monetary contraction.*

During this crisis, it is true that the Fed and Treasury have coordinated to an unusual extent, leaving their balance sheets and policy objectives interconnected in new and complex ways. However, reports that the Obama administration would kill Fed independence are greatly exaggerated, at least at this point. **Structurally, nothing has really changed in how monetary policy is decided given the Fed's pre-existing mandates. Although the eventual exit strategies of policy accommodation will likely be unpopular in political circles, the Fed has faced that challenge time and again.**

Moreover, the Fed does have ways of systematically unwinding the assets off their balance sheets. Different ways include open market operations, Treasury deposits, and outright sale of assets. The Fed can raise rates and maintain enlarged balance sheets now that Congress has given them authority to pay interest on bank reserves. By paying rates on reserves, banks can earn a nice spread between what they pay their depositors and what they Fed pays banks on the excess reserves, effectively killing the multiplier effect and preventing banks from making loans as the economy picks up steam. However, will the Fed be able to pull the plug if and when the economy recovers and banks decide to start lending these excess reserves causing an increase in broad money supply and potential inflation? Do we believe that the Federal Reserve (and Congress) will select the precise timing of when to withdraw the money from the system so that a recovery will be sustainable and inflation does not take hold? That remains to be seen.

One last point to make regards asset inflation. While all this liquidity is not being used by the economy given the vast resource gap, where is it going besides on bank balance sheets? We

<sup>82</sup> "The Great Inflation Debate", *Council on Foreign Relations*, Charles L. Evans, September 9, 2009.

believe we now have asset inflation and not economic inflation as industrial utilization plummets. Liquidity will not flow into consumer prices directly but will create isolated asset bubbles. Global liquidity is going into equities and commodities instead of into the economy creating this asset inflation. The record low interest rates are forcing investors to part with their cash and put it into these crowded trades. Where are these asset bubbles now? We believe we are beginning to see signs of bubbles in China through their infrastructure and manufacturing capacity increases both of which are long term deflationary in nature. Commodities are also showing some signs of bubble formation in the short term given the hoarding that has taken place by China.

So let us conclude now. We started with two impacts of inflation. One impact is motivated by the expanding Fed balance sheet and the other is motivated by the large resource gaps. Our view is that large resource gaps have been met by a large growth in reserves. In an effort to prevent a repeat of the Great Depression, the Fed acted quickly and decisively over the past year to provide liquidity to markets and to prevent systemically important institutions from failing. On the one hand, the explosion of the Federal Reserve balance sheet has led to an enormous increase in bank reserves in the monetary base. Left unchecked, these monetary facts seem to scream inflation risks – a *potential* ticking time bomb. On the other hand, the unemployment rate is 9.7 percent, and manufacturing capacity utilization is currently only 65 percent, which is the lowest level since this statistic started to be officially computed in 1948. While policy reflation is massive, there are limits and to date, the initiatives have only helped cushion the blow. ***The key to the inflation process is not what the Fed is doing to the money supply but the extent to which, if at all, the “liquidity” is being circulated in the real economy.*** Velocity is still contracting. Rents are declining for the first time in 17 years. Consumer credit is contracting at a rate not seen in 65 years, and this not only reflects a desire to bolster depleted savings rates but also rising charge-off rates among lenders; and, wages/salaries are shrinking at an unprecedented annual rate of nearly 5%. Between rents, credit and wages, we have a deflation on our hands of epic proportions. We have not even addressed the issue of the massive wealth destruction that has occurred during the past two years - a highly deflationary impact. And to top it all off, we believe that the isolated asset bubbles that are forming are in and of themselves, deflationary in nature. We are therefore of the opinion that inflation is benign and will remain benign for some time to come, provided of course the recovery is not much stronger than we predict and the Fed does not fall asleep at the wheel – then all bets are off.

## Investment Outlook

We focus on drivers of return, rather than solely trying to forecast what each asset class may deliver. We additionally believe that a well thought out and globally diversified basket of investments should provide exposure to both cyclical and secular themes. ***Over the next 5 to 10 years, tactical or active asset allocation will be essential to successfully navigating risk markets as investors are forced to consider both large tectonic macroeconomic shifts in addition to specific micro elements.*** Similarly, traditional approach to portfolio construction has overly relied on backward looking assumptions which relied heavily on mean reversion of historic performance, volatilities and correlations. Going forward, under the New Normal, we believe this could lead to suboptimal allocations. ***New means of growth have to be analyzed in a world with much less leverage and with asset prices reflecting overly optimistic recovery scenarios.*** For the first time in the post-WWII era, we have deflation in credit, wages and rents, and from our perspective, this is an ideal situation for a focus on capital preservation as income orientation will be the winning strategy over a strict reliance on capital appreciation.

***That said, from the perspective of macro-analysis, the New Normal is leading us to focus on those countries and/or regions that will benefit from cross-country rebalancing as growth shifts from developed to developing countries. We therefore continue to favor emerging markets that have economically established themselves as systematically significant, with strong fundamentals and reasonable valuations.*** We look to find countries where the characteristics of the New Normal will act as tailwinds rather than headwinds and whose economies will be able to produce positive nominal GDP growth patterns irrespective of artificial stimulus. ***Implicit in this outlook are the emerging Asian countries such as China and India and those countries that are connected with Asian consumption such as Brazil and Australia.***

On the developed markets side, we favor international developed markets, in particular the MSCI EAFE, over US markets for several reasons. First, it reflects a short dollar bias over the intermediate to long term, being fully cognizant that the short dollar trade is very “over-crowded” in the short term and the USD can benefit from any re-flight to safety. Second, international

markets are trading at more opportunistic relative valuations. Lastly, the MSCI EAFE is exposed to commodity countries that should benefit from future emerging market growth.

That said, we continue to maintain sizable equity allocations as a percentage of our overall Global Equity Allocation to Domestic Markets despite our belief that US markets are currently over-valued. We continue to favor a philosophy of positioning portfolios for multiple scenarios, i.e. situations where US equity markets perform well and US markets underperform relative to other markets. ***We have to always keep in mind that despite our New Normal outlook, we believe that in the longer term, new industries will develop in the US that will help its competitive global advantage. Long term US bears tend to forget the favorable US intangibles, namely the best legal and regulatory institutions, some of the world's deepest capital markets, the world's most prestigious educational institutions that conduct the most sophisticated research and development. These are all the positives that lead us to continue to favor our oversized allocation to domestic equities.***

***On the inflation front, we expect to see benign global inflation as well as benign to moderate inflation in the US for some time to come.*** Despite the massive quantities of paper currency printed by world central banks over the past twelve months, we do not see this causing hyper-inflationary conditions witnessed during the late 1970s. This leads us to a favorable outlook for fixed income.

***In the credit space, we continue to favor the front end of the yield curve despite our belief that short-term rates will remain low for extended periods of time and income-producing investments with an international orientation due to our longer-term USD outlook and longer-term potential inflationary pressures leading to higher interest rates.*** We strongly favor credit spreads higher up in the capital structure and increasingly more on international issues, reflective of potential foreign exchange attribution. Because we continue to anticipate public sector involvement in capital markets, we favor those investments that are aligned with friendly government policies, utilizing leverage and/or guarantees to our benefit. ***We reiterate our emphasis on fixed income because of our belief in a benign short to intermediate term inflation environment coupled with very favorable absolute and relative valuations. We focus on corporate fixed income across the credit spectrum as well as the municipal sector because of its very favorable supply/demand dynamics as well as its very favorable valuations relative to US Treasuries.***

From a currency perspective, we are increasingly tilting towards international exposure as we position towards eventual renewed depreciation of the USD vis-à-vis other currencies, as well as to real assets, i.e. commodities. Our belief is that, while the USD is not under threat of losing its reserve currency status over the next decade and given it is probably oversold in the short term as it has been the crowded trade, the USD will be vulnerable on a longer-term basis. We favor the following currencies: the Norwegian krona and the Australian dollar for their strong economies, commodity exposure and hawkish central banks, the Swiss franc for its safe haven play and its current account surpluses, and the Chinese yuan as the Chinese government will meet with greater pressure from the international community to de-peg its currency and let it appreciate versus the USD. How else do we protect against a falling USD? We are very favorable to commodities such as gold, oil and natural gas, as well as the industrial commodities as a leveraged play on emerging markets.

However, we remain cautious in the short term over many of our conviction plays such as emerging markets and commodities because markets have moved up very quickly, anticipating and overly discounting the good news to come. We therefore would welcome a healthy pull-back that could be over 20% to 25% in many cases, allowing us to enter at more opportunistic price points.

## Concluding Remarks

Approximately one year ago the world economy fell into a deep recession and financial crisis. Now, we see some semblance of financial stabilization and economic recovery. However, we should not rush to the punch bowl and declare things are back to normal. The global economy is still in a fragile condition and policy complacency can bring us back to the abyss. Moreover, we might lose the opportunity for major reform of our international institutions to meet future economic challenges such as global imbalances and the preparation of orientation of economic power from the west to the east and from the developed to the developing. As economists debate what letter of the alphabet to use to describe the recovery, i.e. U, V, L, or W, maybe they

should focus on the fact that the recovery hasn't really happened yet. In fact, employment and real income are still in decline, production has been artificially underpinned by what largely seems to have been a short-lived auto bounce and by relentless government efforts to stop the savings rate from rising to spur consumption and more debt creation. Strip out all the stimulus from Uncle Sam and the U.S. economy is still contracting. And the same applies for other developed countries such as Europe.

For decades, successive economic downturns and even threats of downturns have been met with massive monetary and often fiscal stimuli. Debt accumulation and spending imbalances by lower and lower interest rates only made subsequent downturns even more dangerous. Interest rates have had to be reduced more dynamically to get the same and sometimes reduced response from spending. Most recently, new and untried policies such as the TARP and quantitative and credit easing have had to be introduced because we have been faced with unprecedented challenges by this downturn. This mindset has created the rise of big banks that are more global, more integrated and systematic than ever before which leads to the moral hazard of "too big to fail." Similarly, many countries that relied heavily on exports as a growth strategy are still geared up to provide goods and services to heavily indebted countries that no longer have the will or the means to buy them.

Worldwide, central banks have pumped thousands of billions of dollars of new money into the financial system over the past two years in an effort to prevent another depression. Meanwhile, governments have gone to similar extremes, taking on vast sums of debt to prop up industries from banking to car making. These measures may already be inflating isolated bubbles in asset prices, from equities to commodities and there are real risks that inflation would get out of control over the medium term if central banks do not time their exit strategies correctly. Meanwhile, the underlying problems in the global economy, such as unsustainable trade imbalances between the US, Europe and Asia had not been resolved nor even properly addressed. Without solutions to these global challenges, we remain dubious that we can maintain sustained economic growth. Such a scenario will result in the New Normal of slower global growth resulting from greater government involvement and growth gravitating from current account deficit countries to current account surplus countries and emerging markets.

Finally, as macro-economic strategists, now more than ever we need to answer the question of what role the US play in global affairs going forward. The answer to that question directly affects many global challenges, including the role of the USD and its link to commodities, in particular energy and real assets as well as export/import and capital flows. Similarly, although there are many different interpretations a reasonable person can reach from President Obama's winning the Nobel Peace Prize, our interpretation is quite simple: we believe that the world is quite relieved at what appears to be a new US that is no longer interested in pursuing an elitism foreign policy based solely on the interests of the US. It appears that there has been a dramatic shift from an imperialist-type of presidency under George Bush to a parliamentary government under Barack Obama. Rather the world now expects us to pursue a coordinated and unified effort to solve the many new and old challenges facing the world, through sound diplomacy implementing and following international laws, respectful and cognizant of other nations' interests. We look forward to the results of such realignment as it will foster new economic trends and investment opportunities not yet identified and exploited.

Some of the global macro-economic issues we continue to monitor and focus in order to for our investment outlook include:

1. Direction, magnitude and rate of change of global imbalances;
2. Direction and magnitude of capital flows among countries;
3. Export and Import statistics of systematically significant countries;
4. The extent and duration of quantitative easing, term financing and fiscal stimulus efforts;
5. Exit strategy formulation and coordination.

We stand willing and able to address any questions you may have on the aforementioned topics, or any other. As always, thank you for the trust and confidence you place in us as stewards of your financial affairs.

Respectfully,  
**Paul, Wesley, John & the TwinFocus team:.**

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