



Debt, deficits & 'Dr. Doom' : What's

an investor to do?

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- **US Government deficit and debt:** The **US Federal deficit** in the first 6 months of the fiscal year was running at a record rate and may exceed 30% of GDP, the high water mark set after WW II. Debt held by the public is expected to grow to just over half of economic output by 2011, a massive 33% increase since 2008. In ten years time, US interest payments alone will run at a rate of US\$800 billion per year.

- The **Canadian government** --- never known for its forthrightness with numbers --- recently announced a Fiscal 2009 shortfall of C\$50 billion, a C\$16.3 billion increase over 4 months. Observers immediately raised alarms that Canada could be mired in a **structural deficit** (chronic deficits caused by declining revenue, high program costs and rising debt service payments). The **IMF** thinks Canada has room to run a \$50 billion deficit as it is 3% of GDP. In the 1980s, budget shortfalls exceeded 8% of GDP. What is troubling senior economists like **Toronto Dominion's Don Drummond**, is that much of the economy (auto, other manufacturing, exports, oil sands) are hampered while recent budget (big spending since 2000) and tax decisions (2% GST cut) are ill timed. Provincial deficits are also growing rapidly.

- **What are investors to think?** Nothing dramatic will happen overnight. Investors should resist telescoping too far ahead. The macro trends that various analysts are talking about --- inflation, China as a global economic power, peak oil --- will play out over the next 5-10 years, not the next ten months. In the mid term (the next 3 years, our investment horizon), North American economies, after 2010, may experience slowing growth and rising inflation. Steep deficits do lead to a debt treadmill and a US credit downgrade (like the recent UK downgrade) may trigger the US into buying back more of its own bonds (this is known as printing money). The **US Federal Reserve** already pledged this March to buy back US\$300 billion. This is inflationary and may de-stabilize the US dollar. **Marc Faber**, the original **Dr. Doom** (Nouriel Roubini is an impostor?) and publisher of the '**Gloom, Boom and Doom Report**', sensationally suggests that the US may be so mired in debt that the **Federal Reserve** will print money recklessly resulting in hyperinflation, perhaps even on a Zimbabwean scale! We shall see.

- **What's an investor to do?** Cautious investors should primarily hold diversified portfolios of securities providing a *strong yield*, like quality corporate bonds, REITs or stocks with storied dividend histories (including financials). Stocks with valuations based on underlying commodities should provide real returns. Most portfolios should have some exposure to gold (in a balanced portfolio 5% - 7% for now). Some investors are also buying oil. Investments in US dollars should, over time, be hedged to reduce currency risk. Cautious investors will limit exposure to long term bonds, stocks with yields that adjust slowly to inflation (utilities) and consumer discretionary stocks, to mention a few.

- **Financials:** Reviled and beaten up though they may have been, Canadian and mainline US financials have been part of our portfolio because their price was so attractive (much less so now); their dividends are solid; their performance, consistently better than expected; and, because, as the **National Bank's Pierre Lapointe** outlines in a recent research note, their business opportunities are looking up. With the U.S. yield curve up sharply of late and the difference between 10-year bond yields and 3-months T-bills exceeding 350 basis points, the highest level since last fall, the banking sector, looks good because it pays low interest on short-term deposits and gets much higher interest on longer-term loans such as mortgages. Historically, whenever such yield curve spreads exceeded 350 basis points, the U.S. banking sector gained 23% on average in the following 12 months, and as much as 50% in 1985. Since the end of February the **S&P TSX Financials index (XFN)** has shot up about 45% while the broad Canadian market has moved up 25%.

- **The Golden Cross:** following our piece last week on the **Golden Cross** (when the 50 day moving average price crosses or exceeds the 200 day moving average price of a major index signaling the arrival of a bull market) the **Globe and Mail** coincidentally published its own take on it indicating that both the **TSX Composite** and the **S&P 500** indices were at or very near such a point. The **Globe** also pointed out that in all 14 US bear markets studied between 1932 and 2002, a turn-around came following such a cross. For trivia buffs: the opposite of a **Golden Cross** is a **Death Cross**.

- **The Canadian dollar: crazy like a loon?** The C\$ gained 8 cents on the US\$ in May --- the biggest single month jump since 1950 --- closing at 91.6 cents on Friday. The Canadian dollar's strength is a product of US\$ weakness and optimism in response to signs of renewed economic life south of the border. In May, the **TSX Composite** recorded the largest monthly gain (up 11%) in a decade for similar reasons.

- There were too many interesting things to write about this week. So, this is a fortnightly or 'as we see fit' publication.

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