

In market economics there is a model of financial instability developed by **Hyman Minsky** (1992, The Financial Instability Hypothesis). He observed that in good times, investors proceed through three phases of financing as an economy progresses through greater and greater speculative pressure. In Phase One, hedge financing focuses on return of both principal and interest. In Phase Two, speculative financing lenders are comfortable with receiving interest payments only knowing that the principal can be refinanced. The final phase is Ponzi financing (similar to the Greater Fool Theory) in which lenders look to rapidly rising asset values for security and don't expect either principal or interest payments.

Simply, Minsky's view is that *success breeds excess and excess breeds an excess-collapse*, which is pretty much what happened starting in 2007- 2008 when an over-abundance of credit inflated prices of homes and structured debt instruments with the expectation that those assets would never stop rising in value.

The parallel with **Mr. Woods** obviously is this: Tiger's astonishing and excessive success on the golf course created a mind-set (the Ancient Greek's called it **Hubris**) of infallibility and testosterone-fueled pride causing the excesses off the golf course and the subsequent and the very abrupt collapse one November night in 2009.

Tiger, the economy and capital markets are in a post-excess-collapse mode. Tiger until very recently could not predictably hit a fairway anymore than the markets can predictably rise moderately and stick above their 50 day average. In this phase, every minute swing of the club and of the markets is obsessively analyzed for an indication of a stable turn-around. So where are we at?

Bears have been grabbing media headlines in the past since 6 months warning of a dire double dip in the U.S. economy. **David Rosenberg**, chief economist and strategist for **Gluskin Sheff + Associates** in his latest missive warns the U.S. economy is in a depression: "After all the monetary, fiscal bailout stimulus, the economy should be roaring ahead, as would be the case if the economy were coming out of a normal garden-variety recession. The fact that there has been no sustained response is testament to the view that this is not actually a traditional recession at all, but something closely resembling a depression", he writes in the **Globe & Mail**. His main concern is that the U.S. economy has U.S. \$6 trillion in excess debt that has to be paid down or extinguished in some manner (default or socialized). Of course under this scenario stocks are over-valued and bonds and cash are king.

The truth to us however is elusive, just like knowing where Tiger's game is really at. There are other points of view.

John Aitkens, Investment Strategist with **TD Newcrest** on August 25th, maximized stock exposure to 65%, and sees a 'soft landing' (growth in the U.S. economy slows to 2.3% in line with historical precedent). This realization will trigger a stock market rally as investors finally breathe a sigh of relief and turn bullish in response to the heightened level of M&A activity and to rising corporate dividends. In his view, the **S&P 500** will rise by 50% in value over the next two years, but with a majority of the price gains coming early and therefore the asset class to be overweight in now is stocks. The soft landing view is predicated on 4 indicators: a positively sloped yield curve which is traditional an indicator of economic growth; rising M&A activity indicating both companies and banks like the future (and so investors should too); a rising rate of dividends indicating that companies are confident that earnings are sustainable; no aggressive new rounds of lay-offs as a result of the soft landing. Ongoing unemployment is a problem, but it isn't getting worse.

This view yields a portfolio with a 65% allocation to stocks that is over-weight financials, technology, industrials and consumer discretionary and underweight gold as the flight to safety will be reversed. The drag on gold stocks will hold back the **TSX** compared to the **S&P 500**. We would add that the **S&P 500** holds a significant proportion of international companies whose revenues are 50% or more from global sales and for this additional reason the **S&P 500** remains attractive on a Canadian dollar hedged basis.

Meanwhile **Stéfane Marion**, Chief Economist and Strategist with **National Bank Financial Group** in his September letter also opines that a soft landing is in the works in 2010-2011. With the risk of a European economic fiasco receding and highly accommodative monetary policies in Asia continuing, global growth will decelerate but not contract. Trade volumes today are back at their previous peak, as 12-month growth exceeds 20% and industrial output in emerging markets is now 11.9% above pre-recession levels. Europe managed 3.9% annualized growth in the second quarter. Such a global

expansion cannot be sustained as advanced economies slow, but that implies slower growth rather than outright contraction.

The situation is mixed in the U.S.. Many of the U.S.'s unemployment woes however can be attributed to the decline in housing construction and other related areas of activity, and this is nothing new, and therefore not a reason to believe things are getting worse. U.S. economic growth for 2010-2011 will be 2.3% - 2.5%. Not spectacular, but growth nonetheless. Mr. Marion is uncertain about U.S. fiscal policy but given domestic conditions (political and economic) we feel it is unlikely the brakes will be applied swiftly. In Canada real GDP now exceeds pre-recession levels and growth is quite robust although the recent retreat in homebuilding may cause (because of the high multiplier effect of home construction) the economy to slow down here as well.

In Mr. Marion's view, equities have reasonable upside --- double-digit earnings growth in 2010 has fattened corporate coffers so it's reasonable to expect support for stock prices as firms buy back shares, raise dividends or make acquisitions. Equities are set at 55% of the portfolio with a discrete overweight to energy and industrials and greater exposure to Canada and emerging markets than to U.S. stocks.

Back to **Tiger**. He too is negotiating a soft landing. The scandals are slowly fading, the divorce is in and the golf game is showing signs of life. His focus --- not unlike that of policy makers --- is to restore confidence and then regain lost ground. He probably will not win an event this year (the golf season is nearly done) but watch out in 2011!

In our balanced view, we have a foot in each camp but leaning to the 'soft landing' view in part because strategically speaking, with a three year investment horizon there is room to be optimistic and because it's obligatory to hold index-tracking stock instruments when the current dividend yield is approximately 2.1% for the **S&P 500** versus about 1.25% on 5 year government bonds. Canadian spreads are slightly smaller.

When the rubber hits the road: How about this for a leading indicator --- the **Ceridian-UCLA Pulse of Commerce Index**. This index tracks credit card purchases of diesel which is very closely correlated with trucking activity and overall economic activity in the U.S.. In July the index jumped 1.7% which is in line with the U.S. economy surging ahead by 5% according to respected forecaster **Ed Leamer**, a professor at **UCLA** who also helped develop the index. As an aside, freight rail traffic, a classic indicator of economic vigour, is also up all over North America.

The conclusion: Mr. Leamer is guardedly optimistic. The current situation, with U.S. housing starts and car sales far below their peaks of years past, means there are no bubbles left to burst --- or in more technical terms, cyclical components are unlikely to retreat further. "Unemployment may continue to surprise in the wrong direction ... [but primarily] People are nervous. Even small news items about problems in a place like Greece are enough to make people run back to cash", he says.

Our advice: don't throw yourself in front of truck!

For more info call Mark Kryzan or Terry Shaunessy at 403-802-3108.

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