Market Perspectives

MAY 2010

As the Water Hole Shrinks

An old African proverb says "as the water hole shrinks, the animals look at each other differently." As we contemplate the global financial picture, that proverb is definitely apropos.

From 2007–2009, the world witnessed a financial turmoil comparable to the Depression. Armed with knowledge and experience from the long, post-Depression recovery, central banks (monetary policy) and global governments (fiscal policy) intervened to an unprecedented degree. Last March, market confidence returned and for the past 15 months we have witnessed a rally of epic proportions.

Last week, markets witnessed significant dislocation as the troubles of Greece and the EMU hit home. The Euro was collapsing and bond markets lost liquidity. In very short order, the previously presumed "containable" Greek problem had spread to the other PIIGS (Portugal, Ireland, Italy, Greece & Spain) and markets were selling off. What was originally a $30Bn backstop for Greek debt maturing in 2010, turned into $1Tn to backstop not only Greece, but the other PIIGS as well. In providing this unprecedented backstop, the EMU went "nuclear" in the hope that a one-time blast could restore confidence to a shaken market. While the nuclear shock worked on Monday, only time will tell whether the bleeding was fully stopped.

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The other side of the backstop is a condition on EMU governments' meeting specific spending cut targets. In Greece, the proposed spending cuts were met with riots; in Spain, unions are up in arms. Everyone likes spending financed by debt; no one wants to take responsibility to pay it back.

We believe interest rates will remain on an upward path as the water hole of savings is draining faster than it is filling. In the 2008 crisis, banks required significant capital to assuage fears of illiquidity and governments borrowed to provide those monies. Now it is not just the banks, but governments themselves that are calling on the financial system for relief. The presumed no-risk status of sovereign (government) debt is being called into question.

There is a disconcerting moral aspect to the sovereign debt issue. In a word, savers are being forced to provide for spendthrifts. That can only go on for so long before the thrifty take to the streets, as looks to be the case in Germany. We are not immune. If the IMF backstop to Greece fails, as an IMF member, the Canadian government will bear part of the burden. With every bailout (banks, autos, countries) this "moral hazard" presents an ever-growing systemic risk. **The bottom line is that as everyone else's money is now spent, we are looking harder at where our own money is going**.

We do not believe the consequences of the EMU bailout will be a death knell for markets. Nevertheless, to mitigate risk, we have limited our fixed income exposure, preferring equities which pay growing dividends. In the fixed income securities we own, we remain short in average term-to-maturity. Our equity bias is towards companies where exposure to broad economic swings is limited. We expect Pipelines, Communications, Financial Services and Infrastructure companies to best weather any storm, as they have in the past. We believe the Canadian landscape is one of the most prudent places in the world and expect to see more global dollars recognize our prominent status. While the current volatility is disconcerting, the market nonetheless remains in the trading range we established earlier this year.