March 31, 2011

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What We Think…….

The debate raging in the halls of the Federal Reserve, now being played out in a most public way across mainstream media is at once intriguing and instructive. Intriguing because it sheds significant light onto the machinations of Bernanke's Fed in contrast to that of his guarded and rarely-challenged predecessor. Instructive because it demonstrates just what is at stake and why the Fed is faced with such a difficult analysis of what is the correct path forward. Of course the challenges facing the Fed are often difficult, and one always run the risk of looking at the past through rose coloured glasses – who would deny the Fed faced enormous challenges in 2008. However today's cocktail of monetary and fiscal policies (many of uncertain consequences), commodity markets, failing U.S. housing sector, sovereign debt problems, natural disasters and restless regimes is particularly potent and necessitates thoughtful and measured response. For investors the challenge is even greater as they must also digest the one additional ingredient of Fed policy itself.

At this particular junction with the Federal Reserve having clearly exceeded its traditional role of engaging in monetary policy through short-term interest rates, it is more important than ever to understand which way the wind is blowing at the Fed. As outgoing Fed governor Kevin Warsh noted in a November op-ed piece in the Wall Street Journal: "The Fed's increased presence in the market for long-term Treasury securities poses nontrivial risks that bear watching. The prices assigned to Treasury securities – the risk-free rate – are the foundation from which the price of virtually every asset in the world is calculated."

Bernanke is clearly on the dovish-side, and as Chairman, one would assume his opinion carries more weight than the rest; however his desire to promote transparency and his sanction of vocal dissent may suggest otherwise. Never-the-less, he has remained committed to the non-traditional monetary policies already enacted, and has suggested that he is not yet worried about the inflation. Of the more vocal members of the FOMC, William Dudley (New York Fed), and Bill Evans (Chicago Fed) appear to support Bernanke's current policies. On the other-hand Richard Fisher (Dallas Fed), Narayana Kocherlakota (Minneapolis Fed), Charles Plosser (Philadelphia Fed) and non-member James Bullard (St. Louis Fed) have all been outspoken in either dissention or tendency towards hawkish policies going forward. This may be a situation where the silent majority holds the balance, and much of that majority (non-district Fed governors on the FOMC) seem to support the house view – but it is hard to say.

There is no doubt that for the Fed to enact effective monetary policy, debate is necessary, however at this juncture the risks of an incorrect policy move are particularly acute for the domestic and global economy. So what are the factors facing the Fed:

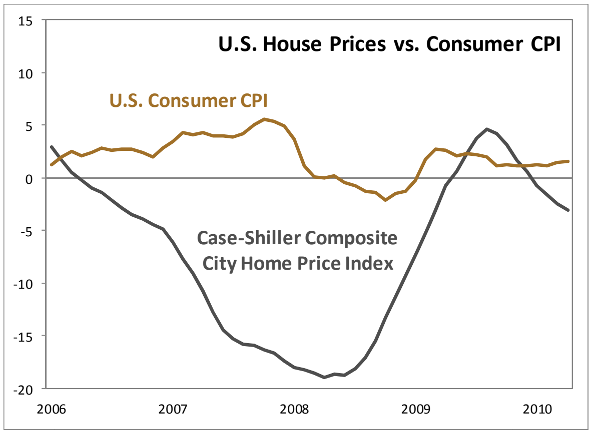
1. Oil: Gas prices that had troughed at the end of 2008 had already begun to rise last summer. WTI Crude oil prices advanced from $67 in May to $108.24 at last look. While the unrest in the Middle East and North Africa has caused real disruption mainly in Libya (only about 2% of world supplies), it has caused a degree of unease amongst oil traders. At present oil prices are far from the debilitating levels seen prior to the debt crisis in the summer of 2008, when WTI rose to $145. However, there is no doubt in our minds that current levels will already be exerting pressure on household disposable income which will likely play out in at least the second quarter. What's-more, we feel it may be premature to expect that the worst impact on Middle East oil supply has already been seen. The future of the region is at cross-roads and the west has proven its inability to predict and influence political change. We won't bet either way except to say that we are unlikely to see the risk premium in oil prices dissipate soon. In any event, the increase in oil prices has been a significant factor for those who are calling for higher inflation.

2. Housing: There is still no evidence that the U.S. housing market has bottomed. House prices have continued to fall as depicted by the Case-Shiller Composite Home Price Index which dropped by 3.1% yoy to January. Without stabilisation in the housing market, we expect the rebound in employment to remain muted. In addition, with so many mortgagors under water – the stock market has been a necessary offset to supporting consumer confidence – any tightening of monetary and fiscal policies will likely deflate stock prices and reduce that offset, thereby posing a serious challenge to that confidence.

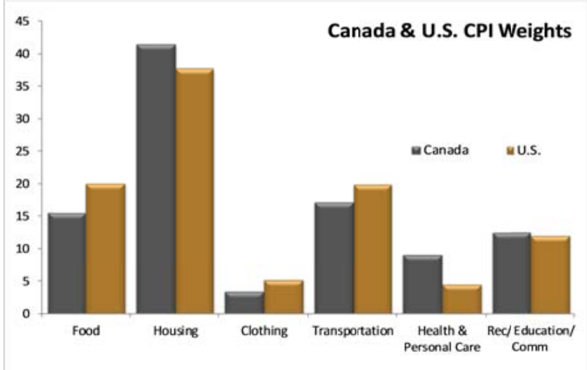
3. Manufacturing: Manufacturing has been the one bright spot in the U.S. recovery with the February's ISM Manufacturing Index posting its highest reading since May 2004. A decline in the U.S. trade weighted dollar back to pre-Debt Crisis levels has aided export of U.S. manufactured equipment to rapidly growing regions, notably the BRIC countries. This is a sign of U.S. growth coming from beyond the consumer – a transfer that has been sought after, but elusive for much of the last decade. The sensitivity of this sector to future U.S. monetary policy will be pivotal to the Fed's ability to tighten policy without damaging the economy. On the positive side, modernisation of developing economies has years to go; on the negative side, the pace of this modernisation will be negatively impacted from higher inflation expectations and the policy responses in those countries and from the Fed.

4. Inflation: Higher food and gas prices have resulted in some increase in inflationary expectations. However, it would be inaccurate to characterize the response of inflation hawks at the Fed as solely originating from concern over higher commodity prices. There is certainly a fear amongst some FOMC members that the removal of liquidity in the banking system must begin before it becomes irrevocably inflationary. We remain of the opinion that as long as labour markets remain loose – headline unemployment has fallen by 1% from its recent peak to 8.8%, but total unemployment is still over 15% – broader inflation is unlikely to take hold.

Hawkish FOMC members are concerned that liquidity that has been injected into the global economy is at risk of precipitating broader inflation and is thus no longer appropriate. We are not as confident as to the solid footing of the U.S. economy, so we are not in agreement with the timing. However, we are not ignorant of the fact that the low cost of capital coupled with the assurance of a stable policy environment has resulted in inflation of risky assets globally, with the secondary effect of increased global demand for commodities. In our view there is a legitimate concern that if left alone for too long, pipeline pressures and imbalances will eventually develop in various regions of the world; although it will probably take longer in the developed countries where unemployment needs to recede first.



The large weighting of housing in the measurement of consumer price inflation is preventing higher commodity prices from pushing U.S. CPI higher. Note that U.S. house prices, according to the Case-Shiller index have not yet bottomed.



Source: Bureau of Labour Statistics, StatsCan & Lorica Investment Counsel Inc.

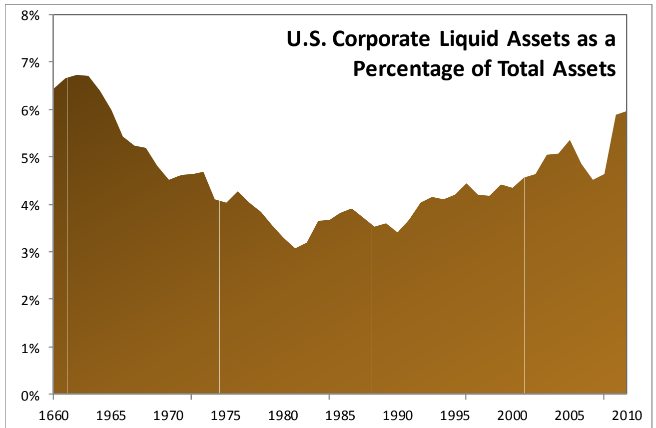
5. U.S. Budget: The U.S. budget has been pushed off the first page by a host of competing stories from around the world. However, we think that it is a story that is worth paying attention to and one that various members of the Fed have been trying to make front and centre. The sheer magnitude of the U.S. budget deficit has made the job of the Fed that much harder by exerting an upward influence on bond yields. From a forward looking perspective, the challenge for the Fed will be balancing monetary policy with fiscal policy that inevitably is getting tighter. In previous commentaries we have suggested that fiscal policy has likely peaked in terms of its support for the

economy. This is perhaps the area that opens the U.S. to its greatest risk of a policy mistake.

6. Sovereign Debt: The most acute sovereign debt problems are in peripheral Europe and we do not believe they will disappear in substance anytime soon. Our understanding of the situation is that bandages have been applied, but no wounds have been treated. We appreciate the difficulty of the situation and the unwillingness of Germans (and of lesser importance, the French) to enter in to another repair job, reminiscent of the financial toll exacted by the Unification of East and West Germany. So for the time being the injured patients in the form of Greece, Ireland and Portugal will have to make do with temporary fixes and the postponement of solutions to sometime in the future. Bond investors have exacted a price on these countries, but are optimistic for other potential patients – Spain comes to mind. Only time will tell if this is the right bet, but recent experience highlights the fine line between risky and risk-less assets. Once liquidity starts to be drained from global monetary reserves, we feel investors will lose some of their enthusiasm for riskier assets including those sovereigns straddling the line. The ECB's preference to appease German inflation concerns on one hand, and the delicate state of peripheral economies on the other leave open the real possibility of a policy mistake as a rate increase appears imminent. We are quick to point out that the U.S. is already an accidental beneficiary of the Euro-zone debt crisis, as the U.S. dollar is the only legitimate reserve currency at this time.

7. Japanese Supply Chain: Like so many of the risks to the economy that have appeared unwittingly, the Japanese supply chain seems to have already been dismissed. We are not experts in this area, but common sense tells us that industries where Japan is still an important supplier will be affected, until Japan is able to rebuild its infrastructure. It is unlikely that parts of the supply chain will be fully broken, but they will be impaired with the net result of slowing global growth in an environment where there are clearly already lots of risks.

8. QE2: The second round of quantitative easing and the accompanying Fed comments was in our view the main catalyst for the rebound in risk assets – the stock market, and economic growth during the latter part of 2010. However, the hoped broadening out of the rebound remains to be seen. Employment growth has averaged 149k for the last six months, better than the 68k of a year before, but businesses are still reluctant to invest their bloated balance sheets in the domestic economy. As a measure of cash on hand, corporate liquid assets as a percentage of total assets are now at the highest levels since the 1960's.



Source: Federal Reserve & Lorica Investment Counsel Inc.

U.S. non-financial corporations are not investing their huge stockpiles of cash and liquid assets – liquid assets as a percentage of total assets are at the highest levels in the last 50 years.

While the announcement of QE2 resulted in an initial rally in government yields, the subsequent sell-off was sharp and material. Long term yields are likely lower than they would be without QE, but on their own have not delivered much stimulus to the domestic U.S. economy. The biggest direct beneficiary of QE2 has been risk assets with a knock-on effect of higher consumer confidence. We feel that with the present reverberations from the Fed, there is virtually zero chance of any additional monetary support; removal of QE is now on the table.

9. The Fed: "It is better to debat a question without settling it than to settle a question without debating it." (Joseph Joubert). It is possible that what is taking place at the Fed is merely debate and at the end of the day the doves will preside. We are inclined to bet

that the noise from a very vocal minority represents a cagey movement in Fed policy, especially given their influence and our estimation that Bernanke is not inclined to take all the responsibility of the Fed upon himself. This means that investors will likely have to contend with a reversal of monetary policy, or even just the expectation of it, sooner than they expect. Given that the Fed's non-conventional monetary policy has been through quantitative easing, we expect that it will direct its activities there first. Interest hikes would follow, although there is a risk that the Fed may choose to exercise both together. (One might argue that the compromise within the Fed will be to reverse QE now for higher Fed Funds later.) Regardless, Quantitative tightening will likely put pressure on risky assets, and perhaps some pressure on longer term government yields – the latter being more difficult to predict.

10. The Bank of Canada: The markets are no longer pricing in a Bank of Canada rate increase in June and now have priced-in only one increase by year-end. We expect that a hike from Governor Carney will be later in the year, if at all, as May's election will keep the Bank on the sidelines. By then economic prospects could have already dimmed from the headwinds we've already noted, which could prevent the Bank from raising rates this year. The recent strength of the C$ will also make the Bank of Canada's life more difficult.

We are reasonably optimistic for Canadian government bond yields in 2011. We feel the Fed has begun to prepare the marketplace, albeit through much disguised means, for a change in direction of monetary policy. While even just the change of investor expectations will likely exert upward pressure on long Treasury yields, we feel the secondary impact to long Canada's will not be as significant. Furthermore, there is a greater likelihood that the change to monetary policy tightening globally will have a greater risk of being premature and ultimately dealing recovering economies a setback which would keep a lid on bond yields, if not forcing them lower.

Finally, we are also concerned that a signal of tighter monetary policy in the near future will reduce investor enthusiasm for risky assets which will result in underperformance of credit investments.

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