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What We Think......

Let us have the courage to stop borrowing to meet continuing deficits. Stop the deficits.

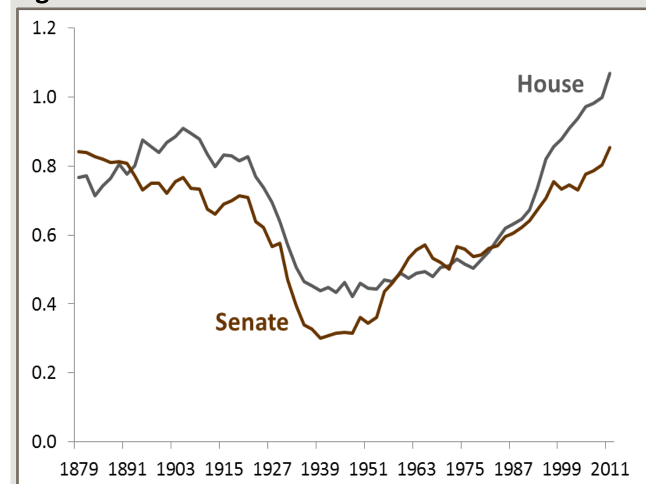
Those words were spoken by Franklin D. Roosevelt during his radio address on the National Democratic Party Platform from Albany, New York on July 30, 1932, ahead of the 1932 U.S. presidential election that he took in a landslide victory over the incumbent Herbert Hoover. In many ways it was not that dissimilar a time to now: several years following the start of the Great Depression (we are now three years from the start of the Great Recession) and U.S. federal government debt to GDP was 44% in 1934 (it is now 68%). The Democrat-Republican role reversal is interesting, but then again, perhaps that is just a function of challenger-incumbent dynamics. However, the electorate voted to go with a new party and the New Deal ensued.

Take a look what Roosevelt said 7 years later in his speech The New Deal Must Continue before the Forum of the American Retail Federation in Washington, D.C. on May 22, 1939.

Our national debt after all is an internal debt owed not only by the Nation but to the Nation. If our children have to pay interest on it they will pay that interest to themselves. A reasonable internal debt will not impoverish our children or put the Nation into bankruptcy.

When Roosevelt was elected to his second term in 1936, the Democrats held decisive majorities in both the Senate (73 of 95 seats in 1937) and House (322 of 435 seats) and a mandate to continue with the Second New Deal. The current president does not have such a mandate and the U.S. government is polarized like never before. See Figure 1. Instead, reaching the U.S. debt ceiling[1] has become the Tea Party and their Republican supporters' *cause celebre* as the most visible and debated measure of the U.S.'s debt problems. The debt ceiling is also the only constraint that requires lawmakers to be somewhat responsive, especially considering lenders' willingness to finance the Treasury – the U.S. dollar's unchallenged safe haven status explains much of this support.

Figure 1 – US Government Polarization



Source: Department of Political Science, University of Georgia & Lorica Investment Counsel, as at Dec 2011

This chart depicts a history of the polarisation of the U.S. congress based on a statistical procedure ("NOMINATE") created by Keith Poole and Howard Rosenthal. The data is based on the voting records of the Senate and House split along the "*'liberal-conservative' spectrum, which reflects the two major parties' division on the fundamental role of government in the economy"*.

The Fiscal Cliff, as Chairman Bernanke coined the likely consequence of enacting the Budget Control Act (unaltered), was put in place to temporarily bridge the divide between Democrat and Republican lawmakers negotiating an increase to the debt ceiling in 2011. While averting the cliff is a valid near-term goal, the real long-term objective needs to be reducing the unwieldy government deficits and debt. The New Year's Eve budget agreement to avert the cliff will effectively reduce

[1] The debt ceiling, restricting total federal debt, was first established when Congress passed the Second Liberty Bond Act in1917, which helped finance the United States' entry into WWI. The first limit was $11.5 billion, today the limit is $14.294 trillion

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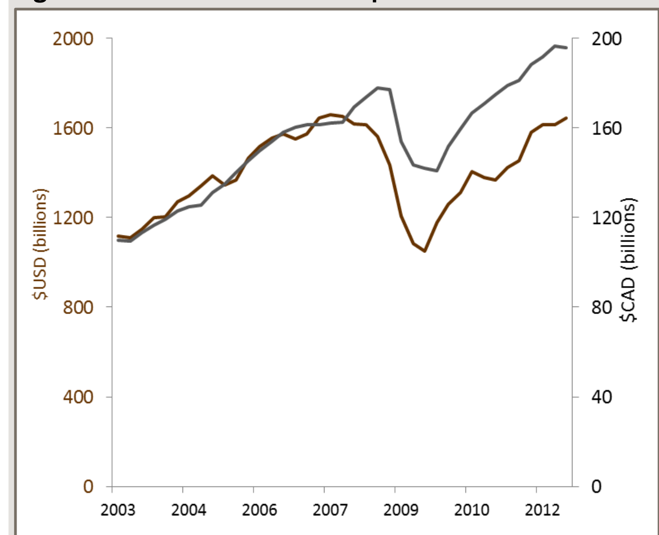
government debt of $16 trillion by a mere $600 billion over the next 10 years, primarily through tax increases on the rich. In terms of the real problems of spiraling debt, the can has been kicked down the road again. The debt ceiling limits will be revisited in February, when we will have another chance to witness the polarization of U.S. government.

Unfortunately, uncontrollable debt and deficits is not just a problem confined to the U.S., but rather a problem that has infiltrated most advanced economies from Italy to Great Britain to Japan. The current solution to high government debt loads in Europe has followed the traditional austerity approach historically advocated by the IMF. However, in a noteworthy report issued in its October World Economic Outlook – *Coping with High Debt and Sluggish Growth* – the IMF suggests that they may have been underestimating the fiscal multiplier and hence the cost of fiscal consolidation. Regardless, spending restraint has ensured that most of Europe, including Germany, will be in recession in 2013. Japan's approach has been just the opposite, with sovereign debt now the highest of any country as a percentage of GDP at 206% (which was only at 20% in the early 80's before Japan's long period of economic malaise). The fact that most of Japanese debt is still financed internally leaves no natural brake mechanism on borrowing, and the recent overwhelming election win by Prime Minister Abe on a platform of fiscal stimulus suggests the electorate is not yet concerned about the enormity of the government's debt. At this juncture, Canada's debt problems are in far better shape than most, but the potential for deterioration in 2013 suggests that Canadians cannot be complacent.

We don't believe that U.S. government borrowing can continue endlessly and at some point there will be an economic penalty to pay, regardless if budget reform is from higher taxes, less entitlement spending or both – growing one's way out of the situation does not seem plausible to us. In the U.S., we anticipate relatively low levels of growth for the foreseeable future with slow improvement on the employment front and few inflationary pressures. Damage has been done to consumer confidence and business investment, and we anticipate further negative economic impact from fiscal restraint. (See Figure 2.) There are some bright spots no doubt – housing, manufacturing and energy, but for every silver lining there's some gray tarnish.

Figure 2 - US & Canadian Corporate Investment



Source: Statistics Canada & Lorica Investment Counsel, as at Sept 2012

Corporate investment in the U.S. and Canada has slowed recently. Uncertainty related to the Fiscal Cliff has prevented business from making further investment.

Housing: The U.S. housing market has shown definite signs of improvement, as evidenced by the 62% gain for home builder stocks in 2012. Prices have risen 5.4% as of October 2012 from the bottom last January according to the Case Shiller Composite-20 Home Price Index, and monthly home sales have averaged an annual rate of 4.62 million, an 8.2% improvement from a year ago. House related employment has increased, albeit marginally, adding 2,000 jobs over the year. Our one concern with the upbeat housing story relates to the decline in inventory of unsold homes and the size of the so-called shadow inventory.

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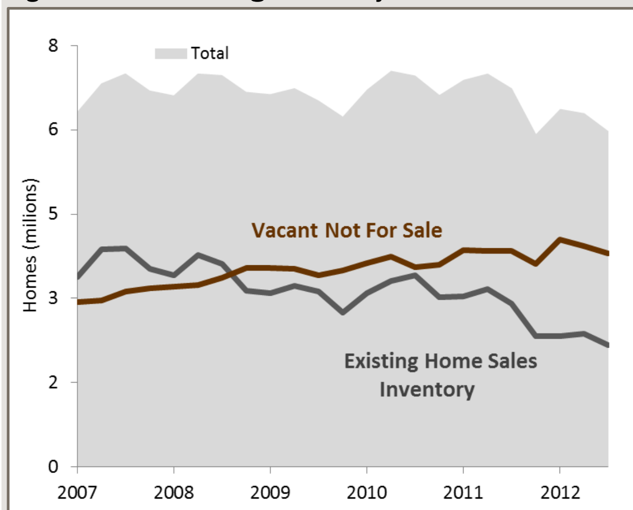
The backlog of foreclosures has improved significantly through a combination of mortgage restructuring, debt forgiveness and paperwork cleanup; many once-vacant homes are now being rented out by former homeowners. However, the numbers of vacant homes not used for seasonal or occasional use has increased significantly. (See Figure 3.) We fear that this inventory may represent shadow inventory that will eventually come on-stream when market prices are higher, thereby slowing the current pace of housing growth.

Figure 3 –US Housing Inventory

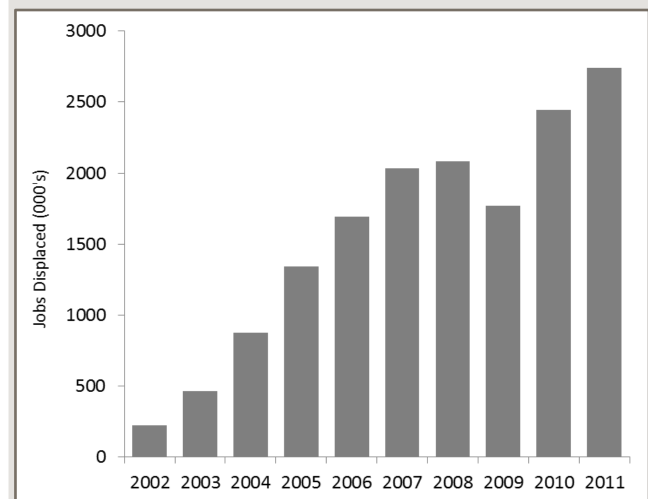


Source: National Association of Realtors & Lorica Investment Counsel, as at Nov 2012

Vacant Not For Sale are existing homes that are vacant, but not used for seasonal or periodic use and are not currently for sale. We hypothesize that a significant portion of these homes will eventually end up as existing home sales inventory.

Manufacturing: There is a lot of optimism surrounding gains made in the U.S. manufacturing sector, with manufacturing jobs having grown for 30 of the past 36 months to December. In addition there have been reports of manufacturing jobs being repatriated to the United States including high profile announcements by the likes of Caterpillar, Apple and even Wham-o. In a 2012 book titled The US Manufacturing Renaissance, authors Sirkin, Rose and Zinser point out that by 2015, assuming current trends, it will make economic sense to manufacture in the U.S., items from seven significant industries that are currently being manufactured in China. (See Figure 4.) We share the authors' (who are all principals or partners of the Boston Consulting Group) enthusiasm, although more cautiously. First, China is not the only offshore manufacturing base that the U.S. need be concerned about – as Chinese wages rise, there are other Asian regions that are attracting manufacturing industry although, as the authors point out, without the same scale, infrastructure, and educated workforce as China. Second, much of what is being repatriated to the U.S. involves capital intensive industry – far less significant in employment terms.

Figure 4 – US Job Loss Attributed to Chinese Trade Deficit



Source: Economic Policy Inst & Lorica Investment Counsel, as at Dec 2011

Following China's admittance to the World Trade Organisation, developed countries have lost significant jobs to China, mostly in manufacturing. The Economic Policy Insititute (EPI), a non-profit, non-partisan U.S. think tank, in its August, 2012 publication *The China Toll*, estimates the number of jobs lost in the U.S. as a result of the Chinese trade

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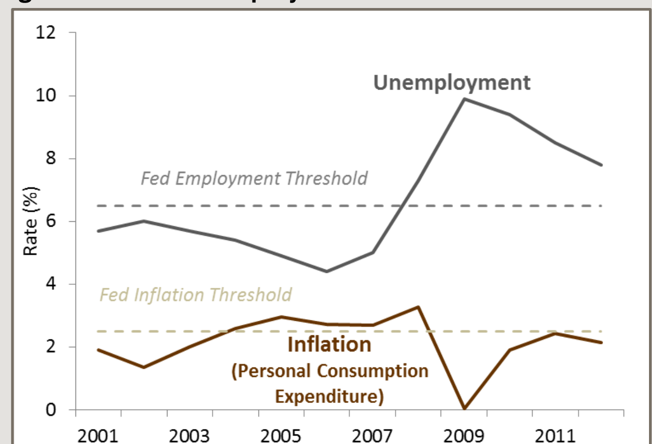
deficit. The EPI base their analysis on trade flows and employment for each of approximately 195 individual industries in the U.S. economy. While a survey of actual jobs lost to Chinese trade would be more valuable and reduce the potential for inherent bias, obtaining Chinese related data is notoriously difficiult Even discounting the EPI's data, we are still left with significant jobs lost to Chinese manufacturing.

Energy: The emergence of new energy supplies resulting from advancements in fracturing technology will eventually produce significant economic dividends, but we think that it may take several years to be realized. From an industrial perspective lower fuel costs should be disinflationary, as well as improve the competitiveness of U.S. manufacturing. From a household perspective, lower oil and natural gas costs should free up money for savings or spending elsewhere in the economy. There will also be the direct impact on job creation in manufacturing and services related to energy extraction and production.

The Canadian economy will derive direct benefit from those sectors in the U.S. economy that are advancing. However, in the near-term we don't believe there will be enough export demand, particularly for manufactured items, to offset a realignment of the domestic economy. The housing market has begun to slow and the trickle-down impact on the rest of the economy is also beginning to show. Although we think the Bank of Canada will eventually respond with lower rates, we also think the Bank will be reluctant to show a connection between easier monetary policy and the housing market. The Bank has been very vocal in its concern over household debt levels and as such, an easing in monetary policy will have to be in response to slowing of the broader economy. As for commodities, we expect it to continue to be a sector of strength for the Canadian economy. Although natural gas prices will likely suffer further because of the additional supply coming from the U.S., oil prices should remain strong on the back of strong global demand.

In this age of substantial government debt deleveraging, substantially through austerity, central banks in advanced economies have been forced to play a more active and inventive role than ever before. The Fed, ECB, Bank of England and Bank of Japan have all inflated their balance sheets beyond levels that were likely ever contemplated. However, we believe that we have already entered a stage where quantitative easing has more impact, albeit diminishing, on asset valuations than on the underlying economy. Furthermore, we believe that concern over inflated central bank balance sheets should be and appears to be growing. According to the most recent FOMC minutes, the asset purchase program has elicited concerns relating to "*financial stability and the size of the Fed's balance sheet"* amongst some Fed members. So while, we expect QE3 to continue for most of this year, we cannot say with much conviction, how much beyond. As for interest rates, we expect the Fed Funds rate to remain unchanged for some time longer, consistent with the rework of the Fed's forward guidance tools, where calendar date guidance has been replaced with macroeconomic thresholds of inflation (2.5%) and unemployment (6.5%). (See Figure 5.)

Figure 5 – Fed Unemployment & Inflation Thresholds



Source: Burea of Labour Statistics, Bureau of Economic Analysis & Lorica Investment Counsel Inc, as at Nov 2012

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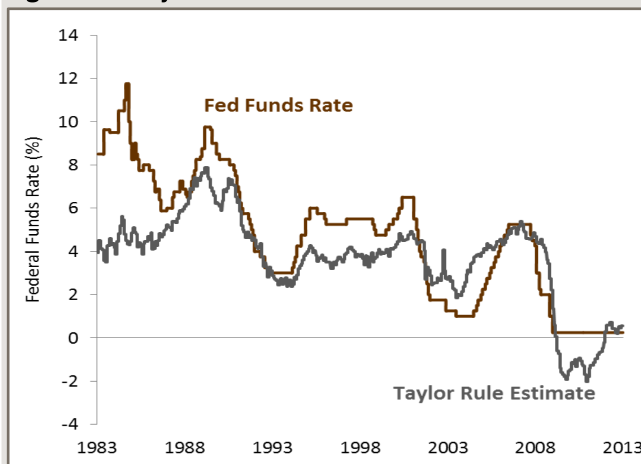
Following the forstallment of the Fiscal Cliff and the release of the FOMC minutes, we have seen a knee-jerk rise in North American bond yields. Ten-year treasuries and Government of Canada's now sit at 1.87% and 1.92% respectively. We have also seen a steepening of yield curves – the treasury curve has steepened by 20 basis points to 280 bps (2-30's), while the Canada curve at 128 bps, has only steepened by 7 bps. We are not surprised that yield curves have steepened in response to the sell-off, as the guidance for stable overnight rates has been unam-biguous, especially in the U.S. (See Figure 6.) For longer term bonds, our forecast is for yields to remain within a trading range, and the recent rise represents a move to the higher-end of that range. Although the Canadian yield curve is quite a bit flatter than the U.S. yield curve, for the time being we expect any lasting steepening of the Canadian yield curve to be driven by the front-end, rather than a rise in long bond yields.

Figure 6 – Taylor Estimate vs Fed Funds

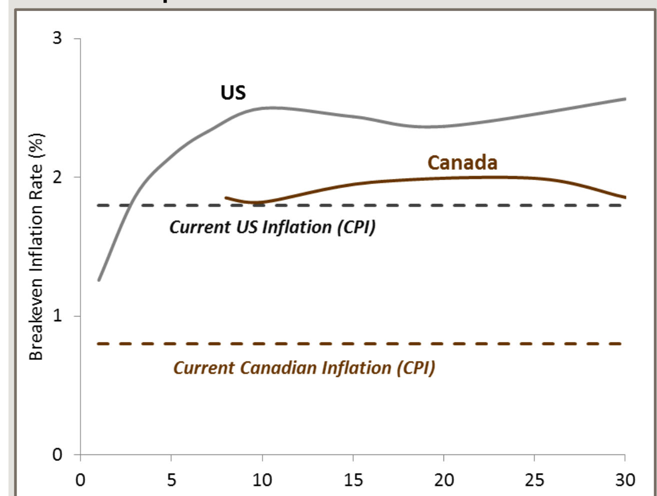


Source: Bloomberg & Lorica Investment Counsel, as at Jan 2013

According to the Fed's forward guidance, it is not likely to raise rates until thresholds shown in Figure 5 are breached. The Taylor rule, a simple guide for short term rates, suggest that the Fed Funds rate is now at an appropriate level, in contrast to the last few years when the *zero bound* caused rates to deviate above the rule.

Although government bonds do not represent particularly good value by historical standards – 10-year real yields are negative in the U.S. (-0.7%) and Canada (-0.1%), we are not yet concerned that flows will migrate away from the sector. Treasuries are still the preferred safe haven for global investors, and for those investors looking for a bit of extra yield in shorter maturities, Government of Canada's offer a reasonable alternative. Furthermore, we see the potential for inflation to fall below expectations in both countries. (See Figure 7.)

Figure 7 – Nominal Less Real Yields – Inflation Expectations



Source: Bloomberg & Lorica Investment Counsel, as at Dec 2012

Nominal less real yields produces the break-even inflation rate or the markets expectation for inflation at various terms to maturity. Inflation expectations are higher than current levels.

Corporate bonds continue to be the preferred sector in the bond market and to some degree the capital markets overall. Although flows out of equity funds and into bond funds has been well documented, the popularity of bond funds is in part a function of investors moving out of independently managed bonds and into managed fixed income. (See Figure 8.) At lower yields, investors are no longer satisfied to

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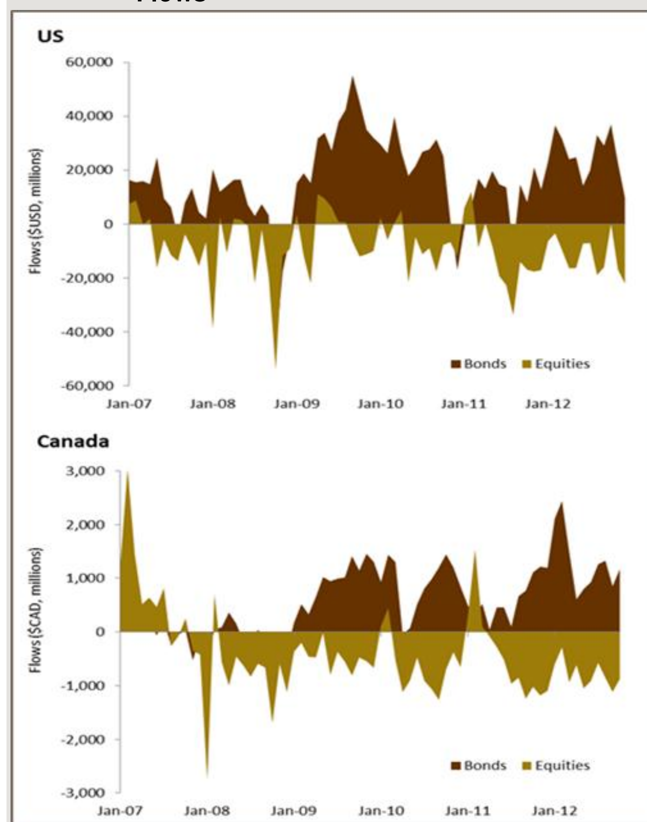
hang onto government bond ladders, and in many cases lack the expertise and access to manage a portfolio that will include corporate bonds and respond to a changing rate environment. Although the corporate trade appears overcrowded, we feel monetary policy will likely continue to support the sector in the short term. Further out, there are risks that a change in the Fed's policy of quantitative easing could adversely impact credit markets, and any change in sentiment will exert pressure on the sector's already poor liquidity.

Figure 8 – US & Canadian Bond and Equity Fund Flows



Source: BMO Capital Markets, Bloomberg, IFIC & Lorica Investment Counsel Inc., as at Dec 2012

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