

*Economic Outlook (continued from 2)*

inventories and will in capital equipment, to fuel growth. In our individual company research, we have found unremitting references to the emerging consumer in developing countries as an area of growth. A burgeoning emerging consumer

supported by a recovering U.S. labor market will be the foundation of growth in global GDP.

**5. Export Spark:** The U.S. economy may find a positive medium-term surprise from

rising exports as developing country currencies appreciate and emerging consumers are drawn to U.S. products and services. ■

## Market Outlook

The precarious market position created by the prospect of doubtful economic growth and an overvalued market directs us to be cautious. The market is indeed precarious because it has, in our opinion, the probability of rising or falling 10 to 20% from quarter-end levels by the end of the year. Uncertainties to be resolved are: a) developed market financial stress relief, b) the strength of developing market economic growth and c) the timeline for U.S. employment recovery.

Our cautious disposition is reflected in the higher-than-normal cash positions held at the end of the quarter; we do not have a predetermined date by when to reinvest the cash. We will nonetheless look for buying opportunities in securities that pass our investment process, provide a fundamentally and technically opportunistic entry price and specifically meet the following criteria:

1. Companies with healthy balance sheets that exhibit flexible capital funding for

growth, industry-beating margins for safety and stable revenue sources;

2. Companies operating in or sourcing revenue from countries where governments meet a minimum interest coverage threshold currently and are projected to do so in the medium-term future;

3. Companies profiting from the production of select fundamentally attractive commodities; and

4. Entities that profit from emerging market consumer spending. ■

## Debt & Deleveraging Theme



*"The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance."*

~ Cicero (106 BC - 43 BC), 55 BC

Cicero's quote is notable not only for its timeless relevance, but for its historical context, dating back to the last days of the Roman Republic – a time of great political upheaval and economic uncertainty, not unlike our present situation. The underlying prescription of austerity, debt reduction and limits on social welfare systems tells us that the issues we now face are as old as the concept of government itself. This is not new, and while some may argue that "this time is different," an eponymous best-selling book<sup>2</sup> argues fairly convincingly that it is not. With the current market uncertainty stemming primarily from the interlinked issues of global debt and deficits, we take a closer look at the global debt problem and what the trend toward deleveraging and eventual austerity are

likely to mean for economic growth going forward. We focus our analysis on the U.S. economy given its relevance to our investor base, as well as its use as a proxy for debt and deficit issues throughout the developed economies. We begin by framing the debt problem in terms of its root causes and explain why its scale makes it particularly challenging. We then discuss the various scenarios for deleveraging and conclude by outlining our investment strategy for the most likely outcomes.

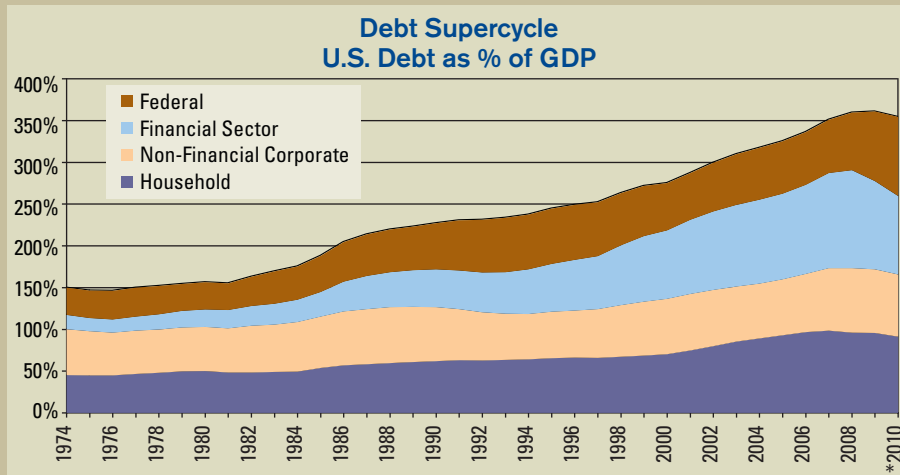
### How We Got Here – Debt Supercycle

To understand how we got here, one must understand why consumers, companies, banks and countries borrow in the first place. Debt is an intoxicating elixir, capable of helping consumers boost their standard of living (by pushing consumption forward) while helping companies boost their growth. Access to low-cost capital, coupled with population growth, technological innovation and productivity gains over the past 30 years, meant that as our collective standard of living improved, so did our aggregate demand for assets. As asset prices increased, so did the capacity to lend, since the increase in the value of the underlying asset (collateral)

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<sup>2</sup>Reinhart, Carmen M, and Kenneth S. Rogoff, "This Time Is Different: Eight Centuries of Financial Folly," Princeton, N.J., Princeton University Press, 2009.

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Source: Bureau of Economic Analysis, Office of Management and Budget, Flow of Funds Account of the U.S. - Federal Reserve. \*1st Quarter

served to drive loan-to-value ratios even lower. Against the backdrop of low interest rates and productivity-fueled economic growth, debt levels exploded. By the time the financial crisis hit in 2008, aggregate debt levels in the U.S. approached 360% of GDP, up 50% from 1990 levels and nearly double from 1980 levels.<sup>3</sup>

Since the crisis, we have witnessed a massive transfer of debt from the private sector to the public sector, driven primarily by the government's role as the lender of last resort in its effort to keep the financial system afloat. While we have recently begun to see some deleveraging at the household and company level, the increase in government debt has meant that aggregate debt levels have remained relatively unchanged. If history is any guide, we can expect the external portion of this aggregate debt to increase. In their book, *"This Time is Different,"* which analyzes 800 years of data on emerging and developed economies, Reinhart and Rogoff found that external debt levels (which includes government and private debt) usually increased by 80% (on an absolute basis as a percentage of GDP) within three years after an economic crisis.<sup>4</sup> As of the end of 2009, the U.S. external debt/GDP ratio stood at 84%. According to Rogoff, that ratio is likely to exceed 90% sometime over the next 12 to 24 months.

**Scope of Problem - Why Excess Debt is Problematic**

The 90% threshold is key, since median GDP growth rates have been shown to fall by 1% once a country's external debt exceeds 90% of GDP.<sup>5</sup> This means that once debt becomes excessive, countries cannot grow their way out of

<sup>3</sup>The Economist; U.S. Bureau of Economic Analysis; U.S. Federal Reserve.  
<sup>4</sup>Huebscher, Robert, "Ken Rogoff Expects Slow Growth and Sovereign Debt Defaults," *Advisor Perspectives*, May 25, 2010.  
<sup>5</sup>Reinhart, Carmen M. and Kenneth S. Rogoff, "Growth in a Time of Debt," *American Economic Review Papers and Proceeding*, January 2010.

the problem. They must proceed through the time-consuming and painful process of debt repayment and increased saving, which could have a negative impact on consumer spending in the absence of real income growth. New research from the McKinsey Global Institute shows that for each percentage point increase in the U.S. savings rate, consumer spending drops by more than \$100 billion – a serious drag on any recovery. The importance of consumer spending cannot be understated, given that U.S. consumers have accounted for more than three-quarters of U.S. GDP growth since 2000 and for more than one-third

of global growth in private consumption since 1990.<sup>5</sup>

While the U.S. has not yet reached the 90% tipping point, looming state and local budget shortfalls combined with pension fund imbalances will likely push the federal deficit to the point at which creditors will begin to demand higher interest rates for U.S. debt. Given the sheer scale of the debt, even incremental changes to interest rates can (and will) create a funding and fiscal crisis. Unfortunately, history has shown us that when it comes to tackling the deficit, governments are not prone to act proactively, especially since tough austerity measures are not popular with voters.

In fact, most respond in ways that initially exacerbate the situation. It is only in times of crisis that constructive measures are taken, since only then are legislators given a political "free pass" to attack the deficit through painful austerity measures. In the U.S., these measures will almost certainly include a substantial increase in taxes, (continued next page)

**What We Have Learned From History**

**What Governments Don't Do With World War Size Debt**

- 1. Slash expenditures on entitlements.
- 2. Reduce marginal tax rates on income and corporate profits to stimulate growth.
- 3. Grow their way out without defaulting or depreciating currencies.\*
- 4. Raise taxes on consumption to reduce deficits.

**What Governments Usually Do With World War Size Debt**

- 1. Restrict overseas investment by firms and citizens
- 2. Oblige central bank and commercial banks to hold government debt.
- 3. Default on commitments to politically weak groups and foreign creditors.
- 4. Condemn bond investors to negative real interest rate

\* Sole exception is Britain 1815-1913 as it was undergoing the Industrial Revolution. Source: Niall Ferguson, "Fiscal Crises and Imperial Collapses," *Peterson Institute for International Economics*, May 2010.

Theme (continued from 4)

### Deleveraging Scenario Analysis

Ratios	Options	Description	Probability	Economic Consequences
Debt/GDP	Excessive (>90%)	Austerity — Increased savings & debt repayment	High if debt ratio exceeds 90%	Low growth/high inflation Median GDP growth falls by 1%
		Default — Partial/full default: restructuring	Low U.S. can always print its way out	
	Not Excessive (<90%)	Austerity — Increased taxes and cuts in public spending (entitlements)	Medium Austerity likely only in crisis	6-7 years of deleveraging in which the debt/GDP ratio declines by 25% GDP contracts for 2-3 years
		Inflation — Printing money: quantitative easing	Medium QE likely to remain in place	Liquidity sets stage for next crisis Obviously, highly inflationary
Default — Partial/full default: restructuring		Low U.S. can always print its way out		
	High Growth	High growth driven by net exports, war, oil booms or productivity	Low Unemployment overhang and lack of export alternatives	

Source: McKinsey Global Institute, Kenneth Rogoff, Matterhorn Capital Analysis

as well as significant cuts to (politically charged) entitlement programs like Medicare, Medicaid and Social Security.

#### Scenario Analysis

Taking into account the existing debt load, as well as lessons from history, what are the deleveraging options available and which are most likely to be implemented? According to a study conducted by McKinsey Global Institute, historical episodes of deleveraging fall into four general archetype: "Belt Tightening," "High Inflation," "Massive Default" and "Growing Out Of Debt."<sup>7</sup>

Assuming the U.S. debt-to-GDP ratio stays below the 90% level, the most likely scenario is inflation (printing money), followed by austerity. Given the Federal Reserve's bias toward keeping rates low for the foreseeable future, quantitative<sup>8</sup> easing will likely continue indefinitely – at least until the Fed is convinced the economic recovery is sustainable without government stimulus.

So what can we expect? Reinhart and Rogoff's data show that the average peak-to-trough decline in the economy lasts

12 to 18 months, followed by a recovery of the same duration, with high unemployment lasting for 4 to 5 years.<sup>9</sup> Given how closely the U.S. has tracked these historical patterns, we would expect another 2 to 3 years of high unemployment along with muted GDP growth.

#### Investment Strategy

Against the backdrop of sluggish growth in (high debt) developed world countries and rising prominence of (high growth) developing economies, we are shifting our long-term strategy to increase our exposure to fiscally responsible, stable growth countries.<sup>10</sup> In particular, we are looking for companies operating in or sourcing revenue from countries where governments meet a minimum interest coverage threshold. These stocks will augment our existing exposure to these countries, including Bank of Nova Scotia (Canadian bank), Canadian Natural Resources (Canadian oil and natural gas), Potash (Canadian fertilizer manufacturer), Research in Motion (Canadian smartphone manufacturer), AsiaInfo Holdings (Chinese IT), CPFL Energia (Brazilian utility) and Yangzhou Coal (Chinese Coal Miner). ■

<sup>6</sup>U.S. Bureau of Economic Analysis, U.S. Federal Reserve, McKinsey Global Institute Analysis.

<sup>7</sup>Roxburgh, Charles and Susan Lund, "Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences," McKinsey Global Institute, January 2010.

<sup>8</sup>The term quantitative easing describes a form of monetary policy used to increase money in an economy when the interbank interest rate (Fed Funds in the U.S.) is either at, or close to, zero (ZIRP). Essentially, the central bank purchases financial assets (mostly short-term), including government paper and corporate bonds, from financial institutions using money it has created. Quantitative easing is sometimes described as 'printing money,' although the central bank actually creates it electronically 'out of nothing' by increasing the credit in its own bank account. "Q&A: Quantitative Easing." BBC. 2009-03-09; Quantitative easing explained, FT.com; Wikipedia.

<sup>9</sup>Huebscher, et al.

<sup>10</sup>Examples of countries exhibiting these characteristics include Canada, India, China, Brazil, Denmark and Sweden.