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2009 – Government Bond Bubble?

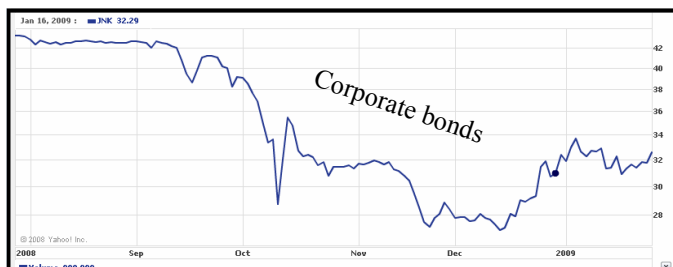
While the precipitous drop in equities in the fourth quarter of 2008 grabbed world wide headlines, the retrenchment in corporate (company) bond markets was even bigger – and much more newsworthy. Ultimately, the final four months of the year will be remembered as a time when governments and investors all realized that credit is the grease that keeps global economic engines running.

- Credit can take many forms – for consumers, it can be mortgages, student loans, margin accounts, or credit card balances.
- For companies it is lines of credit, commercial paper, and corporate loans and bonds.
- Without credit, new homes and automobiles aren't sold, manufacturing plants aren't built, international trade slows, and economic activity deteriorates.

So, when the banks stopped lending, governments worldwide stepped in with big amounts of bailout money. Credit must flow again before there is a recovery.

Why not take advantage of the opportunity?

High-yield and investment-grade bonds may be the most attractive asset class in 2009. Bond valuations are much more compelling than historical averages and present an opportunity for very attractive returns. Compared to government bonds, “corporate bonds ” represent very good value.



Attractive Compared To Government Bonds

Corporate bond or “credit” valuations, yield spreads are at all-time wide levels. (The yield spread is the difference in yield between a corporate bond and a government bond of the same maturity).

A government bond bubble may form because investors are looking for principal protection when stocks were plummeting, and banks were failing. In early January, a Government of Canada 10-year bond was yielding 2.88%. Yields are even lower in the U.S., with a 10-year Treasury Bond yielding 2.45% – one of the lowest levels in the postwar era. With global central banks implementing super-accommodative monetary policies and governments providing fiscal relief, it is unlikely that deflationary pressures will persist for five or 10 years.

“Get out of Government Treasuries”

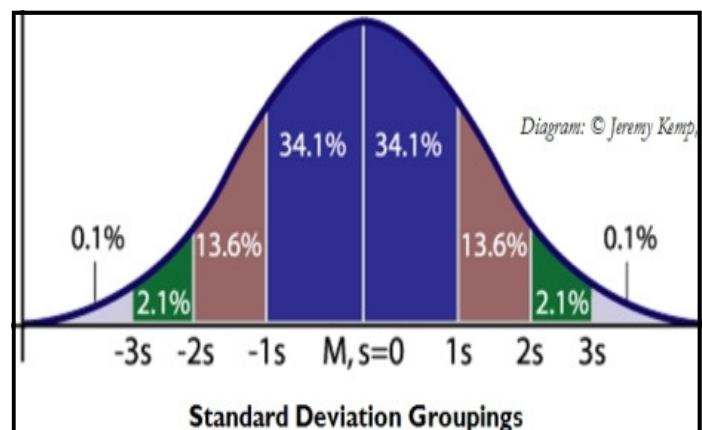
In a recent issue of *Barron's Magazine*, Mohamed El-Erian, Chief Investment Officer of Pimco, a leading global investment management firm which runs the largest bond fund in the U.S., said: “Get out of Treasuries. They are very, very expensive.” Good grade corporate bonds will be a much better investment going forward than government bonds.

What were some key factors that led to the market downturn starting in Oct. 2008?

- The continuation of the credit crisis, and the world-wide deleveraging process, and a forced liquidation and the forced selling of equities, bonds and commodities by *hedge funds* that were faced with substantial redemption.

2008 Once in a Century Phenomenon

From a MATHEMATICAL point of view, we saw something you experience once in lifetime. The standard deviation chart shows that 95% of the time investor returns are in the coloured zones - but the other 5% which is on each side does occur - sometimes.



Managers of Harbor Funds: Bond Comments

“With U.S. 90-day T-bills trading at 0% and 10-year bonds at 2%, I think we’re seeing a bubble in interest rates, which may persist for some time. As a result, fixed-income government securities are unattractive. We have lightened up on government bonds. The weighting is down to about 10%, with 70% in equities and 20% in cash. Given the attractiveness of equities, the focus is going to remain on stocks.”

Equity Comments: “From a valuation standpoint, many companies look attractive because they’re trading at prices we haven’t seen in many years. I think that when the market rebounds on the upside, the move is going to be very big because there is an extraordinary amount of cash on the sidelines.”

Hedge Fund Comments: Hedge funds that have survived are cash heavy, and since they all tend to move as a group, once it becomes apparent the market is on a new upward trend you are going to see an extraordinary amount of cash move into the market. The moves on the upside are going to be as big as what we saw on the downside. I think it will happen when the *economy is terrible*, and the magnitude of the upside move will surprise people, *but that’s always the way it happens.*”

Is The U.S. Headed for Japanese-style Deflation?

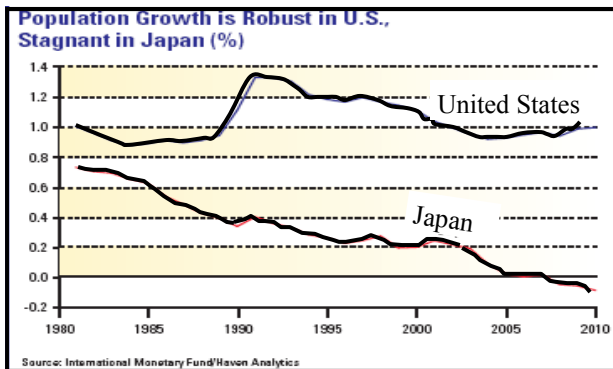
In the wake of a collapsed real estate bubble in the 1990s, Japan experienced more than a decade of weak growth, price deflation and abysmal returns on invested capital. Is the U.S. headed for a similar fate?

Although Japan in the 1990s and the U.S. today share the common scourges of collapsed real estate and stock values and impaired banking systems, we strongly doubt that Japan’s experience offers much guidance to the fate of the U.S. economy in coming years. This has to do with some key differences involving both demographics and economic policy.

Japan’s Demographic Headwinds

The demographic difference is straightforward: Japan faces demographic headwinds to economic growth since population growth has slowed sharply over the past decade and is currently negative. In contrast, the U.S. continues to experience relatively robust population growth of about 1% per annum (Review Chart).

Much of slowdown in Japan’s growth over the last decade can be attributed to demographics. When labour force growth stagnates, economic growth has to come entirely from enhanced productivity, which tends to be challenging to achieve with a rapidly aging work force.



Taking Aim at Deflation

Perhaps reflecting the different demographic backdrop, policymakers in the U.S. have been far more aggressive in fighting deflation than were their counterparts in Japan. There are three critical ways that the U.S. monetary policy response differs from what was observed in Japan:

- (1) the speed of the response;
- (2) the scope of the response; and
- (3) the mindset of policymakers.

With respect to the speed of the response, the difference is remarkable. The Japanese stock market peaked in December 1989 and land prices peaked around the same time. If one takes that date as the peak of Japan’s “bubble economy,” it took over six years for the Bank of Japan to establish negative real interest rates – i.e., short-term interest rates that are lower than the rate of inflation. By that time, a deflationary dynamic had become well established, making conventional monetary policy ineffective.

The Bank of Japan did not establish zero nominal interest rates until February 2001 – *more than a decade after the collapse of the bubble*. In addition, fundamental reforms of the banking system were delayed for more than a decade as well, which kept many insolvent banks and their insolvent companies afloat for years. The result was a proliferation of “zombie” companies, which were perpetually on the edge of bankruptcy and in no position to grow.

In contrast, the U.S. stock market peaked in October 2007 and just over a year later, U.S. policymakers have established negative real interest rates, taken the official interest rate to almost zero, and begun a process of quantitative monetary easing. Although much remains to be done, there have already been massive reforms in the structure of the financial system.

Unprecedented Scope of the Fed's Measures

As *Financial Times* economics editor Martin Wolf observed recently, "I don't think we can learn anything useful from Japanese experience, because, to put it bluntly, the policy of quantitative easing was so incompetently implemented."

Japan's Money Supply Growth Never Recovered

U.S. policymakers are adopting a far broader range of easing measures that have the potential to be far more effective in preventing a deflationary dynamic from being established – even though they are not likely to bring an immediate end to the recession.

The Fed's recent announcement that it will buy \$600 billion in debt and mortgages from government sponsored enterprises and finance \$200 billion in asset-backed securities is another reflection of the massively broader scope of its activities than anything seen in Japan during its "lost decade" of deflation. In fact, it is fair to say that the massive speed and scope of the Fed's balance sheet growth has no precedent in U.S. or global central banking history.

Anti-Deflation Mindset

The final key way in which the U.S. policy response is likely to differ greatly from Japan's experience is simply the mindset of U.S. policy makers. By the speed and scope of their actions, they have already made it clear that they intend to fight deflation with every resource at their disposal. That is totally different from the mindset of Japan's policymakers, who moved slowly and cautiously over many years.

We believe that most of President-elect Barack Obama's incoming economic advisors would likely agree with Mr. Bernanke's bias toward decisive actions to prevent deflation. With proposals for \$600 billion to \$850 billion of fiscal stimulus (up to 8% of GDP) apparently under consideration for 2009, it seems highly likely that active monetary policy will be complemented by active fiscal policy as well. We conclude, therefore, that U.S. economic authorities have been and will continue to be far more aggressive in fighting deflation than the Japanese ever were.

Golden Age Of Finance - And It's Collapse

The golden age of modern finance collapsed in 2008. When the financial system failed, everyone suffered.

Alan Greenspan calls the collapse "a once-in-a-half-century, probably once-in-a-century event."

New Order - More Regulation in Future

Why did America, home to the world's most advanced financial system, turn foreign credit into the world's most serious post-war bust? The suspicion is that American know-how and talent made the disaster worse. Of all the financial instruments to have failed, the ABS type (asset backed securities) of debt obligations have turned out to be among the most devastating. This was a mechanism for converting huge, illiquid assets into liquid financial instruments that could be flogged across the world.

If there were a simple way to prevent crisis altogether, it would already be the foundation stone of financial regulation. The future will be to create a system that supports economic growth through *the best mix of regulation for stability and private initiative*.

Emerging Economies

Emerging economies will also be shaping the future direction of global financial trade. That is particularly true of capital-rich creditor countries such as China. Influence will increase along with economic heft. China's vice-premier, Wang Qishan, reportedly told his American counterparts at a recent Sino-American summit that "*the teachers now have some problems.*" The big question is what lessons the emerging students—and the disgraced teacher—should learn from these recent events.

2008 revised figures revealed that China overtook Germany in 2007 to become the world's third-biggest economy. China's trade surplus rose to a record \$457 billion —50% bigger than in the same period of 2007.

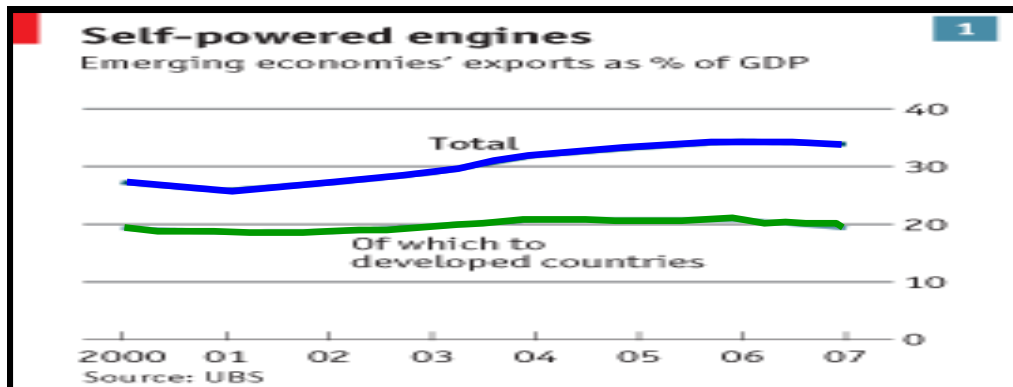
Another piece of good news: following interest-rate cuts and the government's scrapping of credit restrictions, total bank loans in China jumped by 19% in the 12 months to December 2008. China is perhaps the only big economy where credit growth is up in recent months. If that is sustained, it could help to boost domestic spending.

Emerging economies' reliance on America and Europe is often exaggerated. Their dependence on exports to developed countries has barely budged, at just under 20% of GDP. Most of the growth in exports has been within the developing world itself (see chart).

Emerging economies will not return to their exceptional growth rates (no bad thing either, since many of them were overheating).

But it is equally wrong to assume that they cannot recover until America rebounds.

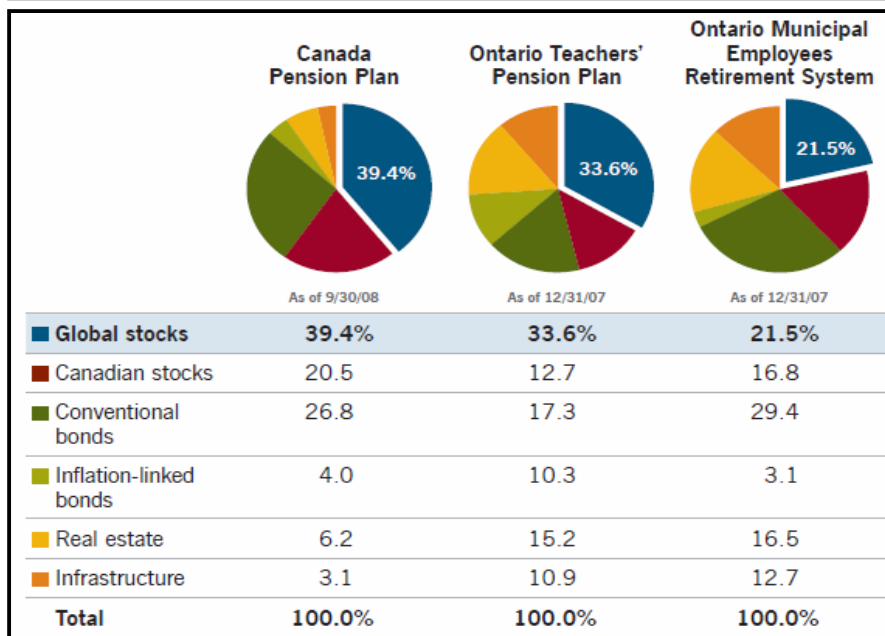
Most emerging economies are not plagued by America's deep structural problems, such as an overhang of debt, which could cramp growth for several years.

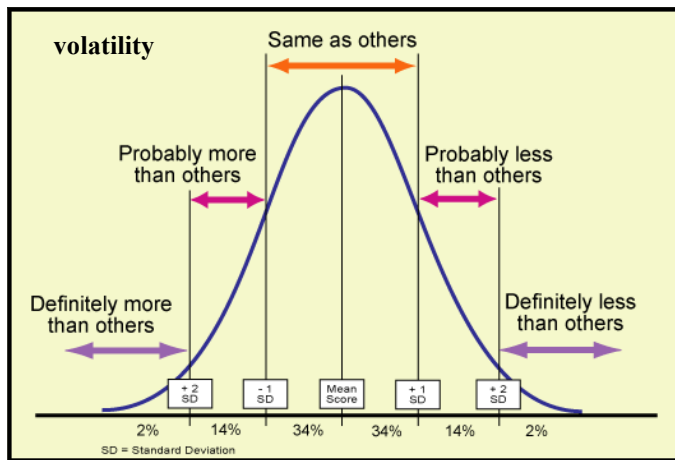


Look to those with the most experience

Canada's largest pension plans, which manage billions of dollars, set a compelling example for a global approach to investing. Their global equity weights range from 21.5% to 39.4% of total assets, revealing that institutional investors still view global diversification as important in meeting long-term investment goals.

While time horizon and risk tolerance may differ for individual investors, these examples serve as a reminder that many portfolios today may need rebalancing.





Smooth returns can be a sign of danger for investors.

The Madoff scandals and stories and volatility:

Low volatility was a large part of Bernard Madoff’s investment appeal. He offered nice, smooth returns—such a contrast with the violent excesses of the stock market. After all, everyone knows that volatility is a bad thing. Right?

This obsession with smooth returns grew, in part, from the way that investment returns are analyzed. Half a century ago little information was available and clients barely knew whether their fund manager was outperforming or more volatile. Eventually benchmarks were established and managers were judged on whether they beat the stock market, average and-or were more volatile.

Academics pointed out that it was possible to outperform in the short term, simply by taking a lot of risk. That led to the widespread use of the “Sharpe ratio.” The ratio looks at the relationship between investment returns and their variability. The higher the ratio, the more reward there is for a given amount of risk.

Clients who use this ratio may end up flocking to a fund who earns a relatively modest return with very low volatility. Indeed, that was an important part of the appeal of Madoff.

Good, erratic or lucky?

It is extremely hard for investors to spot the difference between a fund manager who is able to produce a high, but volatile, long-term return and one who is simply erratic and incompetent or just lucky.

Low Volatility Manager

Opting for a low-volatility manager also has huge potential drawbacks. Where is that low volatility coming from? It might be that the manager is buying illiquid assets. Because such assets are traded rarely, they change price rarely as well. The returns may look smooth but this is an illusion—*property* and *private equity* can fall into this category.

A second possibility is that the manager has adopted a strategy with highly skewed returns; lots of small gains but the occasional big loss.

The *more sophisticated* the fund manager appears to be, and the *more complex his model*, the harder it is for the client to tell whether the strategy will produce skewed returns.

Long-Term Capital Management

Long-Term Capital Management, a hedge fund that collapsed in 1998, was run by highly experienced traders, PHDs and economists. Its performance was brilliant, until it crashed and went bankrupt.

The need to maintain smooth returns also tempts managers to resort to fraud when things go wrong. The lesson applies to company executives as well as fund managers; think of all those firms that made a habit of beating profits estimates by a penny every quarter. A survey of financial professionals undertaken by two academics, Charles Mulford and Eugene Comiskey, both of the Georgia Institute of Technology, found that three of the main motivations for “creative accounting” were to reduce the volatility of earnings, help the company meet forecasts and boost the share price.

Enron was a classic example of a company that pulled out all the stops to meet profit targets. Eliminating fraud may therefore need a change in attitude among investors. *Life, after all, is volatile.* Economies do not grow at a steady rate for ever, as the world is discovering; indeed, previous attempts to avoid downturns may have created the conditions for this recession to be especially severe. Markets do not rise at a steady pace and business conditions do not allow for a smooth rise in profits.

A focus on meeting short-term targets, whether for profits or for investment returns, is likely to be detrimental in the long run.