# Economic Commentary

November 28, 2011

## Politics

Political news continues to overwhelm economics and markets. Politicians have long provided great theater (although they seem to be outdoing themselves these days). The shame is the situation is too serious to be enjoyed. From Washington to Rome to Athens, each morning seems to provide another "are they for real" story. By the way, isn't it somewhat disconcerting that the new leaders in Italy and Greece are both economists. Aren't they the ones that designed the European fiscal and monetary system that has brought us to this precipice? Italy's Monti was in fact an architect of the system.

Germany must eventually admit that bailing out the weak members of the Union is the only answer. While it is against its own laws for the European Central Bank (ECB) to lend to member sovereign nations, it will find a way if only because the specter of countries defaulting is too ominous to contemplate. The ECB will lend to the IMF who in turn will lend to the sovereigns, or the ECB will buy bonds in the secondary market so the banks will be able to support member bond auctions. Directly or indirectly the ECB must be the "Lender of Last Resort". It is an arduous task to get there, but we believe it will happen. It is only a temporary solution, but buys more time to find an answer. The reality is Italy's debt burden is six times the size of Greece. The risk of inflation from too much monetary ease will be trumped by the need to solve the more pressing near term problem of saving Europe and the Euro.

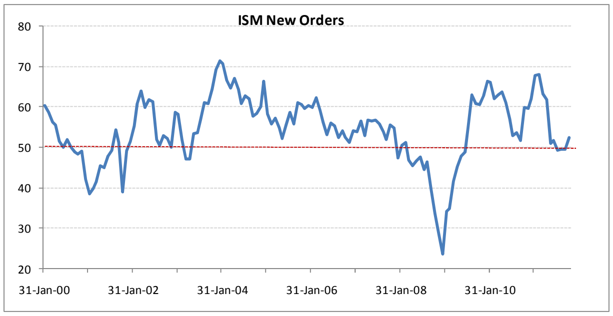
In the US it would seem the Congressional "Super Committee" will not find a way to make the budget balancing measures a reality. It would seem no one expects differently, and the ratings agencies sound ready to ignore it. Any modest deal is likely to be viewed as a positive. The diametrically opposite views of Republicans and Democrats insure [ensure] a lot of political news that will influence markets for the next 12 – 18 months. There is the obvious presidential election next November that will suggest whether the tax-cutting Republicans or the tax-raising Democrats will have the upper hand. However, there is much more to be aware of that will come into effect January 1, 2013, and have an impact on the economy and markets and what US fiscal policy will be, such as:

1. Mandated expenditure cuts due to failure of the "Super Committee"
2. Expiry of Bush tax cuts
3. Health care law and its 3.8% tax effect
4. Payroll tax cut expires
5. US will again be up against the debt ceiling limit in the first half of 2013

## Economics

In overview, US reports have improved, Europe looks worse, emerging nations continue growing while Canada with its resource based economy, is losing positive momentum. Almost every recent US report has been at least a slight positive from GDP to jobless claims to housing. After so much bad news for so long, investors have lowered the threshold for what passes for good news. These positive reports still do not measure up to what is required to solve the deep issues of too much debt in the US. In addition, with no Super Committee agreement for 2012, it is estimated there will be as much as a 1% "fiscal drag" on GDP due to programs not being renewed.

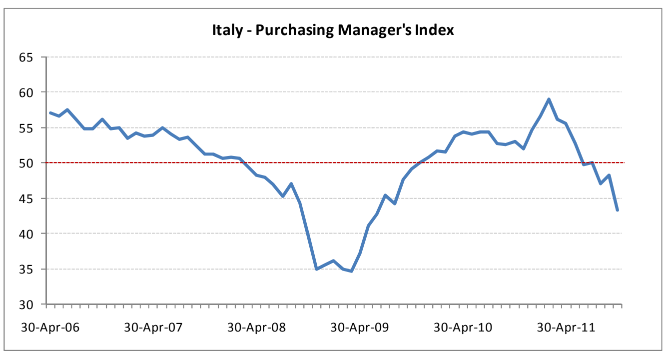
*New Orders in the Manufacturing sector appear to be turning. A reading above 50 shows expansion of new orders.*



The US economy has been buoyed by the consumer continuing to spend. We have two concerns; first the US personal savings rate has dropped to 3.5% from 5.8% in the last year; and secondly the consumer is now 71% of US GDP versus a 60 year average of 65%. Both leave little room for continued spending growth without strong real growth in the economy.

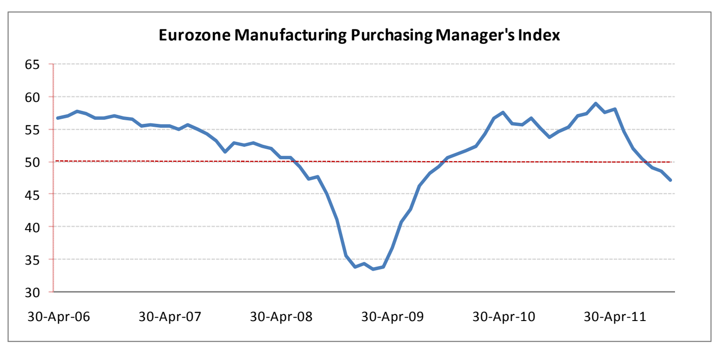
As we mentioned last month, one of the problems preventing significant growth in the US economy is the lack of certainty for corporations and small businesses to invest in producing and productive assets. The Fed can provide easy monetary policy and low interest rates to stimulate investment, but with tax policy and regulation still up-in-the-air in Washington and concerns about global growth, we are faced with what some are calling a "Capital Strike". Amgen, the giant US biotech company provides a recent example of corporate thinking. Amgen issued $6B of debt of several maturities with an average weighted yield of 3.8%. This caused a downgrade of the company's debt rating, and consequently market losses to all of its bondholders. For what use you ask? To buy back $5B of stock is the answer. Not for research, not for a new plant, not to put someone back to work, not to make the economy grow. The money was borrowed cheaply enough that with fewer shares outstanding earnings per share will increase, without having to sell one more pill.

Europe's problems are on display each day as everyone from the head of the IMF and the President of the ECB, to the Finance Minister in China has announced a coming recession. A couple of charts serve to show the direction of European economies.




*Like the ISM in the U.S., the Purchasing Managers Index gives indication of the health of the Manufacturing sector of the economy. A reading above 50 signals expansion. Italy has been below 50 since the end of July 2011.*

*Similarly for the whole Eurozone the Purchasing Managers Index gives an indication of Manufacturing sector across the entire region. The Eurozone reading has been below 50 since the end of July, giving further indication of a contraction in the manufacturing sector in Europe.*




The Chinese government continues to want to control inflation, particularly in the housing market. These measures dampen the economy, but we would still expect growth of around 9%. Of more concern for emerging nations is the weakness in Europe and the US and the effect on exports. China, for instance, has 20% of its exports going to Eurozone members.

Finally, here in Canada, where we have avoided many of the problems outside of our borders, there are increasing signs that globalization is catching up with our economy.

Markets

Nevertheless, whether because of seasonal strength, “climbing a wall of worry”, or best of all a stronger economy, stock markets have maintained a much better tone since the October lows. Investors know that if we read it in the newspaper, the market has already discounted it. Currently though, game changing news happens with such regularity there doesn’t seem to be sufficient time to discount the next market move. Money managers have not experienced a time when so much correct analysis proves to be wrong. For example, the sharp investors who sold US Treasury Bonds anticipating a downgrade by S&P last August were right, but lost money when US yields still continued lower and bond prices moved higher. The forces that moved markets have changed for money managers. As our friend Jason Trennert of Strategas Research wrote, “Few who sat for the Chartered Financial Analyst exam ever thought their job and compensation might depend on Slovakia’s decision to support a European bailout fund”.

The seasonal rally we anticipated was much stronger than we expected. However, the negative macro issues, economic and political, cause us to remain skeptical that markets will show more strength from here. We continue to be active in our selective overwriting and buying put protection due to the wide swings in the market as well as to take advantage of the higher volatility that these wide swings are producing.