QAM Update
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The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

"*Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas.*" - Paul Samuelson, 1970 Nobel Prize in Economics

World Economic Chaos: not so chaotic, not so Economic and not so Worldwide?

One article published in Newsweek in September 1966 included Samuelson's most quoted remark, and a favourite economics joke: To prove that Wall Street is an early omen of movements still to come in GDP, commentators quote economic studies alleging that market downturns predicted four out of the last five recessions. That is an understatement. Wall Street indices predicted ***nine*** out of the last five recessions! And its mistakes were beauties.

But for our clients, and for many investors around the world, the last few weeks haven't felt anything like a joke.

In the midst of this current financial crisis (that analysts estimate eroded about US$ 10 trillion in wealth worldwide in 2 weeks) one client called us to ask if we knew what was causing – in her own words - this "world economic chaos".

While economic uncertainty causes investor's anxiety, it is not necessarily that simple to explain what is causing all this volatility.

On reflection, our answer is that it is not so chaotic, not so economic and not so worldwide, in that order.

Why not so chaotic?

Because life and human history are chaotic in essence. The problem is that the human mind craves order and therefore tries to fit everything into a perfectly harmonious scheme, but this is counter natural. Some call it an "economic order", some call it civilization. But in reality the world is a lively, vigorous and always changing combination of civilization and barbarism, reason and emotion.

Just think, in the 20th Century alone: First World War; Russian Revolution; Great Depression; Second World War; Hiroshima; Cold War; Missiles Crisis; the fall of the Berlin's Wall...and this is just the tip of the iceberg.

Also: Antibiotics; Television; United Nations; Women vote and go to university (at least in many places around the globe); Satellites; Blocs of Economic Integration; freight containers; interconnectivity; Internet… just to name a few.

In all this chaos there are periods of prosperity, periods of convulsion and periods of rebalances. Many analysts suggest we are currently going through one of those moments of convulsion and rebalance.

Why Not so Economic?

One of the main problems analysts are describing is a lack of leadership and political conviction. The United States has a severe leadership crisis; politics complicate the economy. The right prefers to take the world to the edge rather than cede an inch on its positions. Barack Obama does not seem to know how to negotiate with them (or he is not allowed to).

Whether we like it or not, the United States still represents 25% of the World Economy. It is not a meaningless figure. There is still some truth to the old adage that says that when the US sneezes the world catches a cold.

China (the ascending giant) is still a mercantilist nation run by a communist government and very verticalist (democracy, the way we understand it, is still a dream in that country).

Europe has its own big troubles and its enormous contradictions (we won't even start with the immigration issue). Germany doesn't seem to be taking command and doesn't look interested in leading the way; France has its own severe social problems; the United Kingdom is seeing higher unemployment and inflation (and everything else that we see on TV) and Berlusconi is busy with an active social life instead of solving structural problems in the Italian economy (high debt in relation to GDP, low productivity, almost negligible research and development).

Japan has huge demographic problems. An older population and zero immigration. No demand or significant growth will come from that area.

In the middle of all this, everybody is vilifying the US Dollar but…what about the Euro? Without more integration on the fiscal and political front among the members of the Eurozone (very difficult to articulate) the Euro is very hard to sustain.

Why not so worldwide?

There are areas of the world that are doing well. Some groups of people in those areas, and other not so prosperous areas, are also doing very well. One of the consequences of globalization is that prosperity mutated from having a geographic dimension to something different, not subject to boundaries.

Areas of the world: even today some zones in China are experiencing annual growth rates in the order of 10%. People in those areas live with a standard of living that is significantly better compared to 10 years ago, and unthinkable only 20 years ago. If that is a crisis, please give us two.

Groups of people: Lots of people in the farm industry (and land owners) are enjoying significant increases in revenues as the food commodity prices keep escalating, driven by an increasingly hungry world. Highly-skilled people and professionals are doing relativity well, and projections are they will continue to enjoy prosperity.

Many of the largest companies in the world that operate in the Americas, as well as in Europe and developed Asia, have lots of cash in their balance sheets and show high profitability ratios compared to historical standards.

Every time volatility increases in the market, pundits come from different disciplines with books and theories of why this particular time is different. While we understand that there are dynamics and paradigms that change, and players that will gravitate more than others, we don't really think that it is all that different this time.

In today's age of split-second, up to the minute news, many investors are experiencing information overload while being as focused on the short-term as they have always been. Historically, stock prices have been influenced more by emotion than fundamentals in the day-to-day trading but by fundamentals for longer periods of time.

Market perspectives and portfolio positioning

Short-term volatility causes anxiety. This is one of the basic principles as to why investing in stocks has received a premium return over other asset classes over long-term horizons.

We see value in the S&P/TSX; the S&P 500 and EAFE and expect that longer-term investors, positioned in solid companies with reasonable economics and prudent management, are going to be compensated handsomely for their patience in the next 2 to 5 years.

We believe that the equity markets are not overvalued compared to their long-term average P/E, dividend yield and earnings yield relative to 10-year government bonds.

Behavioral finance teaches us that one of the main biases of investors is extrapolating recent behavior while underweighting long-term averages.

One of the tools to counteract this bias is the discipline imposed by an Investment Policy Statement. Having a long-term asset mix and professionally investing to it, including rebalancing when necessary, is the single best way to avoid being a victim of this bias and selling in moments of turmoil only to miss when the markets turn positive.

We feel that inflation is still the number one risk for the long-term investor and are fully aware of the challenges that the current environment represents in the Fixed Income space. For our Fixed-Income Policy, we still suggest a conservative mix and shorter duration compared to the market.

We remain firm in our belief that inflation protected growth in the long-run comes from holding high-quality stocks, while liquidity requirements and stability has to be provided by a cautiously selected Fixed Income position in the portfolio.