

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

“The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists” - Ernest Hemingway

The media continues to focus on a long list of worries as we write this update that are affecting the mood of investors and traders around the world. We don't see the point in going through the entire list here as it is too long and it would be beyond the scope of this update; nor do we necessarily share all of these worries.

But there is one worry in particular that we feel is important enough to mention that will affect investment and economic decisions for quite some time.

We are close to the official end of the U.S. Federal Reserve's quantitative easing (QE2) in June, and investors are questioning how risk assets will react to the end of the of this program that, in short, is not much more than buying up bonds with newly printed money.

The Federal Reserve's duties fall into four general areas. The area that occupies the media and investment analysts the most is to conduct the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates.

Unlike other Central Banks around the world (including the Bank of Canada), the Federal Reserve has a clear mandate, as part of its mission statement, to try to affect the economy in a way that employment is generated and maximized. It is not a secondary objective; it is just as important as maintaining stable prices.

This explains why US Treasury bond rates are so low that most parts of the treasury yield curve offer negative real returns for investors at current expected levels of inflation.

This phenomenon of maintaining low rates has been explained in a recent paper by authors in the National Bureau of Economic Research (one of the USA's leading nonprofit economic research organization) using a term first introduced in 1973 by Stanford economists Edward S. Shaw and Ronald I. McKinnon: Financial Repression.

In short, Financial Repression can be characterized as consisting of any of the following key elements:

1. Explicit or indirect capping or control over interest rates, such as on government debt and deposit rates.
2. Government ownership or control of domestic banks and financial institutions while placing barriers to entry before other institutions seeking to enter the market.
3. Creation or maintenance of a captive domestic market for government debt achieved by requiring domestic banks to hold government debt via reserve requirements, or by prohibiting or discouraging alternative options that institutions might otherwise prefer.
4. Government restrictions on the transfer of assets abroad through the imposition of capital controls.

Not all governments are created equal.

There are governments that we cannot bring ourselves to lend our spare change to. Many of them have a history of defaults. Current conditions contribute to generate increased level of probability of defaults (technically meaning not paying a coupon or returning the principal when due). Governments that fall into this category are likely to use all forms of “Financial Repression” described above.

Some governments have serious fiscal problems; still, we think the probability of seeing them defaulting in our life time is as remote as convincing our teenage kids to stop texting and using Facebook. Lenders will be paid interest and principal as promised, however it is likely to be in a devalued currency (meaning they will return to investors less purchasing power). Governments that fall into this category are likely to use only one or two forms of “Financial Repression” described above and within closer limits. The usual suspect here is the United States government.

This devaluation of the United States currency is not without benefit to the U.S. economy and corresponding “challenges” to other world economies. The United States exported more goods and services in March than in any single month in its history: US\$172.7-billion. It was the country’s 21st consecutive month of rising exports, and the year-over-year increase was 20.9 per cent.

Markets analysts anticipate that the United States up-trend in exports could last for years and turn its intractable trade deficit into a surplus. The Boston Consulting Group (BCG), a global management consulting firm, talks of a “renaissance” in manufacturing that will, within five years, lure major U.S. corporations to return home from China.

There has been an article on the globally followed magazine “The Economist” about the same phenomenon.

The dramatic increase in the cost of labor in countries in Asia (particularly China), increasing energy and transportation costs and the spare capacity in the United States makes it more convenient for manufacturers to produce locally.

This trend (that is nothing more than people and companies adapting to new conditions) creates demand for labor and limits the unemployment and recession level as well as negative real yields.

Benjamin Graham, known as the father of value investing, used to say that in the short run, the market is a voting machine but in the long run it is a weighing machine.

In the short run politicians, lobbyists and the media have an effect on markets and move prices and rates (which is nothing more than the price of money) accordingly. In the longer run the forces of the market are too strong and prices return to their long-term sustainable mean.

Market perspectives and portfolio positioning

After over two years of extraordinary returns as the markets rebounded from the extreme lows of March 2009, we are observing some indication of fatigue. The S&P 500 hasn't done much on a year to date basis and the TSX is showing year-to-date negative returns as we write this update.

Even though we think that the S&P 500, EAFE and to a lesser extent the S&P/TSX are not overvalued compared to their long-term average P/E, dividend yield and earnings yield relative to 10-year government bonds, they are not trading at the deep discounts they were two years or one year ago.

It is common to see all sectors and most individual stocks rise during broad recoveries. For this reason many traders and speculators like to add "torque" to their portfolios through "high-beta" stocks in up trending markets. That is what they did during the last two years.

The beta of a stock is nothing more than the relation of its returns with those of the market as a whole. Usually those companies more sensitive to the economic cycle, those with lower capitalization and those with higher risk show a higher beta.

Speculators and traders are starting to trim high-beta exposure.

Large-cap equities hold up better than small cap equities in more fairly valued markets. We see less risk in large-caps and accordingly expect large-cap stocks to outperform small-cap equities in the near future.

Companies with strong balance sheets, competitive advantages, sound economics and reasonable valuations are inherently of higher quality and outperform the general market in more challenging times. We expect companies selected using a value style approach to outperform the index in the near future.

Though we understand that markets are rational weighing machines in the long-run, we also know that markets can stay irrational longer than a person can remain solvent, as Sir John Maynard Keynes put it very aptly over half a century ago.

This is why we recommend investors to be committed to their long-term asset mix and be cognizant of liquidity issues that may affect their ability to ride volatile markets without jeopardizing their long-term results.

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