Quadrant
ASSET MANAGEMENT
QAM Update
November 2011

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

"*...Europe exemplifies a situation unfavourable to a common currency. It is composed of separate nations, speaking different languages, with different customs, and having citizens feeling far greater loyalty and attachment to their own country than to a common market or to the idea of Europe*" – Professor Milton Friedman, The Times 19 November 1997.

Europe and lessons from the past

"…Households don't operate like this and neither should countries. When your credit card is maxed out, you don't go out and get another one and continue to accumulate debt at 18 per cent interest. Instead, you figure out a way to restrain your spending and you increase your payments to reduce your debt…" Finance Minister Jim Flaherty as recently quoted by the media.

There are a few inexactitudes in the Finance Minister's quote. No surprises there. He is, after all, a politician trying to make his point.

The first one is the idea that all households control their spending and do not accumulate debt beyond their ability to repay.

If that was the case, then the ratio of debt to personal disposable income in the household sector for Canada wouldn't have grown to 148.7%, as reported by Statistics Canada, reaching the highest level since the agency began compiling the figures in 1990.

If all households by themselves were absolutely rational and knew their financial limits, we wouldn`t have witnessed the mortgage crisis that the US is still trying to weather.

But even more misleading is Mr. Flaherty's idea that countries operate like well coordinated households. For the most part, they do not. There are many reasons for this dissimilar behavior. We won't elaborate on all of them in detail here, but some of them are:

1) Unlike a household, the people in governments who create the problem are usually not the same ones in charge of solving it (let alone the people who actually bear the costs).
2) There is a natural tendency of governments to overestimate and place excessive hope on their taxing power.
3) Governments and households have very different timeframes - for households it is an entire lifetime and extends to the next generation; for governments, it is just the time to the next election.

If history is a guide, countries for the most part inflate their way out of fiscal problems with more money in some shape or form. Call it debt (promissory notes issued by the government) or currency expansion (promissory notes issued by the Central Bank).

The Euro-zone is at a critical point. As we have mentioned in past QAM Updates, there is no simple solution. It is becoming more and more clear that the crisis is getting to a point where government action has to be taken or markets and people will force it. Markets have so far been whipsawing, on the positive with hopes for a solution, and on the negative with discontent in periods of disappointment. But if the situation continues to deteriorate, bond markets could force policy makers to make the decisions in a reactive way. James Carville, an advisor to Bill Clinton, once famously said he would like to be reincarnated as the bond market, because then "you can intimidate everybody".

One possibility is greater integration, with a common fiscal policy including common bond issuance, which implies greater costs for the "stronger" countries (i.e. Germany and France) and fiscal dilution. The other is break-up, which implies costs and disruption for every country.

As of the end of November, yields on German 10-year government bonds have risen 25 basis points to 2.15% even as the euro-zone crisis has deepened. Up to now, whenever the crisis became more intense, German yields have fallen and the yield premium for bonds of peripheral Europe has risen. Analysts interpret this shift as a sign that the end of the European drama is approaching and there is a growing belief that the crisis will be resolved with the introduction of euro bonds rather than the euro's collapse.

The German Council of Economic Experts proposed a plan in early November that endorsed joint European bonds. Under the plan, countries would pool any debts exceeding 60% debt-to-GDP for eurozone countries into a temporary fund that would issue joint sovereign debt. Any country that contributed debt to this fund would be subject to automatic fiscal regulations, which would give central European executives the ability to intervene in national budgets, etc.[1]

New bonds will create more money that will buy more time and will benefit some sectors; more money that will allow some politicians to claim that they saved the European Union; and more money that (the only thing we are sure of) won't help savers in Euros and Fixed-Income instruments in the long run.

Market perspectives and portfolio positioning

Markets do not like uncertainty and uncertainty continues to dominate the picture and is the force driving investors' sentiment.

In October markets were positive. The S&P/TSX Composite Index ended 5.6% up, the S&P500 Index returned 5.5% in CAD terms and the MSCI EAFE Index gained 4.3% also in CAD terms.

As we write this for November, the S&P/TSX Composite Index has lost close to 5%, the S&P500 Index declined a little over 1% in CAD terms and the MSCI EAFE Index is down more than 7% in CAD terms.

As of end of October YTD numbers are: -6.9% for the S&P/TSX Composite Index, 1.2% for the S&P 500 in CAD terms and -6.4% for the MSCI EAFE Index in CAD terms.

At these levels, volatility becomes unnerving for most investors and many start to question their position in the stock market.

A study published in 2006 by Standard and Poor's titled "Major Bull Market Corrections and Recoveries in S&P 500: 1970-2006" showed that the average market decline during that period was 13%. The market recovered within a 3% band (average 12%) in 71 days after reaching the bottom. Full recovery was around 117 days after reaching the bottom on average. More often than not that recovery is powered by a few good days of prices appreciation of 2, 3 or 4%.

We continue to recommend investors stay invested for the long run and committed to their long-term asset mix. The problem with market timing is that we do not know when the market reaches its bottom and by staying out of the market during a recovery, the volatility experienced becomes a permanent loss of capital.

(1) http://www.businessinsider.com/eurobonds-actually-make-sense-2011-11

Disclosures
This report is prepared for the use of Quadrant Asset Management personnel and clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Quadrant Asset Management. Any unauthorized use or disclosure is prohibited.
The information herein was obtained from various sources and Quadrant Asset Management does not guarantee its accuracy.
Neither Quadrant Asset Management nor any director, officer or employee of Quadrant Asset Management accepts any liability whatsoever for any direct, indirect or consequential damages or losses arising from any use of this report or its contents.