Solving The Chinese Puzzle and Staying Invested – A Fine Balance of Moving Forward Carefully

One of the most dangerous phrases heard within investment circles is that “ it’s different this time”. In one sense this is true, as no two cycles are truly alike. However, a closer look at past recessions shows that the severity of the recession and the following recovery were largely influenced by the external shock or policy changes that preceded the downturn and that deep recessions are almost always followed by steep recoveries. The circumstances surrounding the current environment however, are far more troubling. According to the IMF, recessions associated with a financial crisis have been more severe and last longer than those resulting from other shocks. Furthermore, recessions that have spread around the world have been longer and deeper than those confined to one region. This explanation is consistent with the current downturn, which has been unusually severe and suggests that this recession will be followed by a sluggish recovery.

While it is clear that the tentacles of the financial crisis wove themselves around the global economy, the unprecedented coordinated response by G20 nations finally seems to be loosening that grip. *We appear to be past the worst of the downturn*. Implementing both monetary and fiscal policies, governments and central bankers have planted what appear to be the seeds for recovery and “green shoots” are sprouting. The recovery in the economy requires the banking system and credit markets to operate properly. At present this is not the case although the situation is improving with the number of new issues increasing and the demand for them being strong. Credit spreads had ballooned at the start of the crisis but have since fallen back. Although global economic weakness continues, the pace of deceleration has started to slow with many economic indicators seemingly in the process of bottoming. Further gains in oil and commodity prices are signs that markets are anticipating the return of economic growth.

While history has proven that global economies eventually will recover, questions abound as to timing, leadership and the quality of such a recovery. It will not be as easy as a “V” or “U” or “W” shaped recovery that many economists would have us believe. China will probably be the first major economy to restore positive growth momentum. They did not suffer from many of the problems that plagued other major economies and have the flexibility to enact expansionary macroeconomic policies quickly. The U.S. economy continues to face some formidable challenges, but given the unprecedented stimulus that has been applied, it should be one of the first economies to post positive growth numbers. The U.K. economy, which in many respects mirrors its American counterpart, may turn the corner later this year or in early 2010. In contrast, the Euro-zone will likely lag due to its tepid policy response to date. Japan will also be one of the last major economies to emerge from this current downturn. Canada should be dragged along with any recovery south of the border and benefit from a pick-up in global demand for commodities.

With markets having caught spring fever on March 9th, 2009 we’ve seen a change in investor sentiment – from fear to greed. While many have begun to embrace this as the beginning of a new bull market, we believe that until we see the underlying fundamentals improve rather than just decline at a slower rate this remains part of the bottoming and turnaround process. With newly added risks from the escalation in oil and commodity costs, along with rising interest rates, we would not be surprised to see markets take a breather. Portfolios have reached a point where they need to be positioned for what we see as a dull cyclical recovery. It was Benjamin Graham who once said “when bargain opportunities virtually disappear, past experience indicates that investors should take money off the table”. As evidenced by our portfolios’ returns for the first half of 2009, asset mix decisions are crucial. Our portfolios entered 2009 with equity weights well below benchmark. We continued along these lines until mid February, when, seeing many stocks selling below fair value and offering compelling long term prospects, we increased equities. Some of our key moves included establishing/increasing positions in Canadian banks, increasing energy and basic materials (including food). Stock selection continues to be a critical step in our process. During the first half of 2009, the majority of our companies met or beat earnings expectations, with 11 of them increasing their dividends.

Canada

Unable to dodge the financial crisis and the U.S. recession, Canada's economy is experiencing its worst contraction since 1990-91. Undoubtedly, as an economy we continue to have our wagon hitched to the U.S. market. Although very severe at first glance, the current downturn stands in sharp contrast to other recessions. Job losses have not been as massive and have been concentrated in the manufacturing and construction sectors. The housing sector is also benefitting from the enormous monetary easing, an indication that Canadian banks have passed along most of the Bank of Canada's rate cuts. Home sales have shot up with the 3 month growth rate working its way back to a level that is probably the envy of many foreign observers. Speaking of being envious, Canadian banks stocks, having escaped the losses experienced by their international peers, have successfully raised Tier One capital levels and seem to be ready to return to a business as usual mode. This is being confirmed by a recent Bank of Nova Scotia report showing a jump in lending activity in the auto market. All of this seems to have shifted Canadian consumer confidence levels in the right direction. The widening Canada/U.S. income gap should also prove to be a positive. Over the last 4 years, Canadians' disposable income has increased twice as fast as that of their American counterpart. Meanwhile in Canada, the number of jobs created in high-paying industries continues to rise, while in the U.S., they continue to fall. This is a trend which is expected to continue in the post-recession economy. With Canadian consumer confidence data clearly pointed in the right direction it would not be a surprise to see consumption bottoming. The $50 billion plus fiscal deficit wouldn't normally be positive for the loonie, but with long term fundamentals in its favor, we look for it to continue to appreciate over time. On a relative basis, things are looking up for the Canadian economy.

United States

While the Obama administration has made significant headway in calming financial markets and restoring consumer confidence to some degree, the country remains in a very challenging economic and financial environment. Automatic stabilizers have kicked in to help offset private sector income losses and Obama's stimulus package ($787 billion) is expected to create 5 million jobs by the end of 2010 and into 2011. To date only 5% of this money has been spent. With waning financial stress there should be enhanced opportunities for economic growth. Even the Federal Reserve has recently offered glimpses of optimism indicating it no longer views deflation as a threat and offered the first hints that it may be contemplating removing some stimulus from the marketplace. Businesses have done a reasonably good job of aligning production and employment with weaker economic conditions and with the recently released productivity numbers there may be less need to reduce employment. Deep cuts in both fixed investment and inventories have delivered cash flow benefits which have been supplemented by significant stock revaluations. What has been impressive is that the corporate sector's unprecedented cash flow surplus has been achieved in the context of a falling level of sales. U.S. companies have also benefited from the substitution of domestic sales for imports. Obama's grand "bank fix" is a blue- print designed to further restore confidence in U.S. markets and the banking system. The reforms are wide sweeping, ambitious and designed to provide a sturdier foundation to the U.S. financial system. A key indicator of where we stand is the Federal Reserve's survey where they ask financial institutions if they are making it easier or more difficult to obtain a loan. Latest results clearly indicate that the worst is behind us.

Asia/China/Japan/Emerging Markets

In the wake of the global financial crisis, Asia's power is likely to grow and it has a chance to take a position of leadership in the world economy. The resurgence of Developing Markets this year, excluding Japan, has reignited the decoupling theory – a belief that these economies can continue to grow strongly despite a sharp downturn in the developed world. These markets have greatly outperformed their developed world peers since the start of the year, accelerating since risk appetite began to improve in March. China appears to be past the worst and may be entering a period of sustained recovery. Growth is bound to be reported in the range of 8.0 – 8.5% for this year, but our sources connected with the compilation of the data suggest that 7.5% may be more realistic. The key takeaway from visits is the widespread and massive amount of speculative activity which is underpinning the economy. There is just too much easy money flushing through the system, a development we find dangerous and worrying. The recession in Japan is painful. Not only is the Japanese economy highly correlated to global demand, but several structural issues offer challenges that impact domestic demand. If global demand picks up, its manufacturing industries can get back to the business of exporting. Known for its significant store of natural resources, Latin America also provides a developing consumer market for goods and services. China, India, Brazil and Russia (BRIC) will become the engine of growth for the future in the next decade.

Europe

Unfortunately the Euro-zone economies continue to contract and many indicators point to a deep recession. The response of continental policy makers has not been very aggressive and the ECB has been slow to implement "unconventional" policy steps that both the U.S. Fed and the Bank of England have undertaken. German policy makers on the other hand, have enacted a fairly large fiscal stimulus package that may be worth about 3% of GDP. However, the French package has been rather small and that of Italy may best be described as non-existent. Inflationary pressures continue to abate as the gap between what the economy can produce and what it is producing continues to widen. The overall Euro-zone also suffers from a number of problems that will hold back individual economies to different degrees. In Britain, policy makers have responded in an aggressive manner with a fiscal stimulus package targeting infrastructure spending and a cut in the VAT that could be worth as much as 1% of GDP. There are signs that the measures are beginning to bear some fruit as recent economic data seems to imply that the rate of contraction has slowed. Unfortunately, with a host of domestic economic and financial challenges, any upturn will be limited.

Commodities

Future rates of escalation in global demand growth for virtually all commodities are likely to be determined by non-OECD nations. Their current low consumption per capita and rising middle classes will vault them into a leadership role. Over the last twelve months investors' attention has been sharply focused on demand as it has swung from record growth to record contraction, along with the gyrations in global GDP. While the near term outlook for demand is highly questionable the longer term dynamics are both far more certain and positive. For oil, supply/demand has been critical in forecasting near term prices. The future however, will be dictated by the marginal cost of new supply and the degree of energy conservation. With the exception of any incremental supply that may come out of Iraq, the low hanging fruit of global oil supply no longer exists. With regards to basic materials, with the crisis of bank finance having provoked such a drastic curtailment of corporate spending on new projects and expansion plans, supply will be a concern when demand returns. The massive infrastructure spending that is planned by India will have similar effects on construction related commodities as was experienced during China's build out.

Recommendations

The message from equity markets is quite clear: thawing credit conditions, rising orders from purchasing managers, drawn down inventories and a recovery (although still weak) in retail sales are important indicators that the recession is bottoming. The green shoots of recovery may be artificial in nature, but they are sprouting under greenhouse conditions. Short term however, the backdrop for global equities seems to have eroded somewhat. Bearish signals from technical indicators highlight growing caution about the economic outlook and risk aversion. As the greed factor has returned to the markets, we remain comfortable holding equity positions below benchmark levels. The ongoing financial crisis, with its historic dimensions, will not only have a lasting impact on the world economy, but will probably accelerate the shift in economic power from the West towards Asia. With this in mind, direct exposure through select individual equities, country ETF's and our South East Asian holdings, positions our portfolios to participate in future growth. Furthermore, our holdings in commodities – whether base metals or agricultural – gives us indirect exposure to this region as well. Commodities also provide our portfolios with a hedge against what we anticipate will be the eventual return of inflation. While not a problem for the next 12 – 18 months, the inflation which is emerging and should be expected to persist is a mixture of supply side inflation and institutional inflation. The supply side is likely to be concentrated in food, energy and commodities. Our gold exposure also provides a hedge against inflation as well as a hedge to general uncertainty. Since its lows early this decade, gold is up 300%, 194% and 180% respectively against the U.S. dollar, the Euro and Swiss Franc. Applying our barbell approach, we have offset the cyclical sectors with an increased focus on Canadian companies in the more consumer/defensive sectors whose fundamentals remain very much intact. These holdings emphasize quality management teams, visible earnings growth, growth in dividends and high dividend yields. Our fixed income strategy is centered on government guaranteed paper with short maturities, high quality corporate bonds to take advantage of the wider yield spreads and high quality preferred shares (with a reset option).

In the current financial environment trust and competence become even more important factors for our clients. While trust in their money manager's abilities and the quality of advice being provided is important, addressing the emotional side of the business through turbulent times becomes paramount. Successfully fulfilling clients' needs will differentiate the winners from the losers in the next business cycle. Patience is a virtue, for both manager and client, in range bound markets. While there are always opportunities in frustration, it will be focus that identifies them.

ABOUT THE FIRM	CONTACT US
Headquarters: Montréal, Quebec Founded: 1981 Staff: 21 Portfolio Managers: 6 Investment Style: Blended style of management between value and growth at a reasonable price Investment Process: Top-down / Bottom-up Investment Objective: To provide long-term capital growth Assets Under Management: $750 million	 C.F.G. HEWARD INVESTMENT MANAGEMENT LTD. 2115 RUE DE LA MONTAGNE MONTREAL, QUEBEC TEL (514) 985 5757 FAX (514) 985 5755 EMAIL HEWARD@HEWARD.COM WEBSITE WWW.HEWARD.COM

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