



50 Whys to Leave Your (Risk) Lower

“I hope my meaning / Won’t be lost or misconstrued / But I’ll repeat myself / At the risk of being crude / There must be fifty ways.”

FIFTY WAYS TO LEAVE YOUR LOVER, PAUL SIMON 1975

Following the halcyon and unanimously-euphoric conditions of stock markets, commodities and other “risk on” trades in the opening months of the year, recent global cataclysms and societal uprisings will seem such an untimely intrusion. However, the consensus thinking most evident is that these events are exogenous shocks ... things that will hardly change the long-term outlook for this spinning orb. In short, the sudden market dips must therefore be buying opportunities. “At the risk of being crude,” we would say, yes, investors can be expected to rush back in, but are at risk of misreading events. Catalysts and causes are being confused. The “causes” that have led us to prefer lower investment risk, have not changed nor disappeared.

Catalysts rarely prove to be causes ... certainly never the whole of an effect. For example, it makes a difference whether a gust of wind blows you off the top of a 24 foot ladder or its bottom rung. The wind may act as a form of catalyst. The fact that there may a larger impact — a higher, harder fall — than otherwise, depends on “context.” In the case of the terrible catastrophes in Japan, the fact that its government debt level is at an equivalent of 204% of GDP and possessing an aging population, will make any catalyst less easy to refute with humanitarian optimism.

In the sense of global “context” we have been maintaining since our last quarterly portfolio shifts that the global confluence of conditions presently argues that one should move down to the lower rungs of risk. Global financial markets had again ventured into a “high risk” zone (notwithstanding impacts of natural disasters). Multiple signposts of these conditions still remain ... financial, economic, geopolitical, sociological and behavioural. As always, trying to time such turning points is

hazardous. However, better early than too late. In due time, risks always do manifest themselves.

With that introduction, we list 50 points that together describe the context of the current environment. Weighed in balance, they suggest that recent events in Japan and the Middle East have not triggered a long-term buying opportunity. Reactive recovery rallies are likely, however, these events could very well end up being catalysts to much more complicated outcomes.

With sincerest apologies to Paul Simon (and a lament for the refunded front-row tickets to the cancelled Simon & Garfunkel tour last year) we count “50 whys to leave your risk lower.” We hope our meaning will not be misconstrued nor unnecessarily repeated.

1. Big macro possibilities are now seemingly ignored by complacent markets — sovereign default risk, the possible end of QE2, commodity strangulation, the prospect of hard landings in some non-advanced nations ... etc. Macro-global instabilities continue to mount, virtually ensuring more problems ahead. Investing today is done against a backdrop of higher risk. Important to note, is that if any OECD nation is to default (i.e. Greece, Ireland, Spain, Portugal ... etc.), the entire risk structure of the world’s banking system’s Tier 1 capital is upended.
2. Middle East conflagrations and Japan’s earthquake have together punctured the extreme market euphoria that existed prior. As such, these events will likely now mistakenly be seen as temporary detours to further long-term optimism. In

fact, other market and economic vulnerabilities were presaging disappointing outcomes. As such, near-term market reaction recoveries are expected to encounter these factors before long.

3. Japan's earthquake-generated dislocations now add to choppy cross-currents. We anticipate international supply chain disruptions for the next few months at least ... likely distorting price inflation trends and modestly slowing international economic growth. Several years ago, this nation already reached the point where household savings rates had fallen to levels no longer sufficient to absorb new government bond issuance. Japan's eventual demise is written in its demographics. But when exactly?
4. The types of macro policy problems that may now emerge (oil shock, inflation, political disruptions ... etc.) cannot be solved with more monetary "easing" or a QE3. There will be fewer policy response options when the next crisis hits. The latter outcome seems certain as no resolutions to the earlier crisis are yet evident.
5. For one, too-big-to-fail (TBTF) financial institutions are now an even bigger potential problem. We will soon find whether "dark matter" on their balance sheets is a major reason why they are not lending.
6. While shorter-term trends in the U.S. economy indeed have shown some stabilization, the sources of growth are not sustainable ... at least, not sufficient to return the economy to longer-term GDP growth of 3% or more.
7. The U.S. shows every indication of entering a period of "global over-reach" (as did Britain in the first half of the 20th century) if it does not promptly deal with its deficits. Spending on defence (18-19% of federal government outlay) will otherwise need to decline.
8. Defaults tend to follow major country financial busts by at least 2 years or more. To us, it appears likely that major country debt restructurings and/or defaults are likely. Taking the path of austerity to lower sustainable debt levels is too unpopular with the electorate. Defaulting or restructuring debts instead, may be an appealing thought.
9. The German Merkel government is under pressure from a populace that does not wish to bail-out peripheral fiscal miscreant members of the Eurozone. Some wiggle room may yet be possible with respect to a permanent Euro lending institution ... and indeed expanding the EFSF lending limits. But, it is only a matter of time before new crises will erupt, and the Eurozone shrinks to the core members. We therefore continue to favor EU core country (preferably German) and "safe country" debt.
10. The recent Obama budget proposal appeared an abdication of fiscal responsibility; effectively a bid to let financial markets make fiscal policy. In other words, it appears that the administration would prefer to blame financial markets for unpopular austerity measures, the impetus delivered by way of more financial tremors. Markets are likely to oblige.
11. Over the past 2 years, the U.S. has propped up household spending by approximately \$1 trillion. Yet, America remains saddled with the weakest economic recovery in the post-world-war period. In the meantime, time is ticking for

continued federal budget deficits of \$1.4 trillion per annum.

12. The U.S. equity market up-trend since September 2010 has been most unique — the longest manufactured, low-volume, low-volatility, rising period in modern financial history. Equities are now priced for sub-par returns. Even U.S. treasury bonds stand to outperform for an interim period. However, given the prospect of perpetual government deficits, longer-term prospects for treasuries are troublesome.
13. As per usual, the absolute level of price/earnings multiples means little without an understanding of the context of current conditions. With above average risk levels, an era of lower GDP growth, and U.S. corporate earnings near 18 year highs (as a % of revenue and national income) current above-average P/E ratios are twice dangerous. A more cautious stance on equities is warranted.
14. Currently, the biggest fear of Wall Street is the possibility that the economy may actually be recovering (bouncing) too strongly thus threatening the easy money and "Bernanke put" of the Fed. We anticipate a contrary outcome ... at the very least, a period of disappointment.
15. Longterm, the most hopeful outcome for the Western world is a "muddle, muddle" scenario of low economic growth; not too warm or too cold to significantly trouble either the bond or stock markets. Due to recent developments, we think the outcome will be more volatile. This suggests that an active tactical approach will remain necessary.
16. A sad triumph: Only 2 years after the stock market lows of the GFC — this itself a warning of the non-sustainability of the status quo — U.S. households are again borrowing, some consumer products companies again eager to relax lending standards. Bets for our hoped-for "Balanced Beam" scenario are off. A more volatile scenario is now likely.
17. On June 30th, QE2 ends. To this point in the program, virtually 70% of new US treasury issuance has been taken up by the Fed. What happens after QE2 runs out? One objective of this policy has been ineffective — restimulating banks to lend.
18. Will there be a QE3? This is a key question as QE2 has been coincident with flying financial and commodity asset markets. Not inconceivably, a QE3 may be marshaled as part of another fire brigade to combat a downturn. That's where the consensus stands to be surprised, as it is now popular to think that QE3 is not even needed due to recent perceptions of economic firming. That's akin to climbing up a ladder and forgetting that it is holding one up!
19. Whither the next direction of U.S. long-term treasury rates? Whom to believe from amongst the elephantine government bond players: PIMCO or Chinese central bank advisors? It all depends upon who is buying or selling. PIMCO has the better track record to date, and no doubt will be preparing to be a buyer. But not before advising Washington to implement a needed QE3.
20. Over the medium term, U.S. treasuries will likely find

support. That said, U.S. treasury bonds will likely experience less of a boost from “flight capital” this time around. Why? There is a greater supply.

21. Speculation in commodity markets has reached a fevered pitch, even exceeding the extremes of 2008. Outstanding futures contracts for various commodities are many multiples of physical storage capacity. Should the global economy slow, as we expect, commodity prices are likely to correct ... at least temporarily dashing commodity currencies such as the Canadian and Australian dollars.
22. A sign of the times? A new meaning for “rock stars” emerges. Resource company executives now are the popular “talking heads” on business media, flogging new mines, the revival of old mines, and rock projects of all types. Apparently, silver is now also an essential vitamin ingredient for your health; therefore, the price is to surge further. Higher commodity prices are attracting new supply. Thus, forces are in play to modulate the surge in commodity prices.
23. The ultimate impact of the various Middle East conflagrations — from Egypt to Bahrain — is both the subject of intrigue and wishful thinking. Do these events really represent the philosophical triumph of personal freedoms and democracy, or simply the alimentary grumblings of empty stomachs? Of one thing we are reasonably sure: Outcomes in each of these different theatres will likely not include a pro-Western shift.
24. That said, anything is possible in the Middle East, and as such, represents an ongoing and potential geo-political powder keg. However, the resultant speculative impact upon oil prices will unwind back to real underlying supply/demand factors eventually. Whatever new governments or despots there may be, they will all likely welcome oil revenues.
25. Global economic growth expectations are likely to be disappointed in 2011 (even before the advent of Japan’s disaster). Leading the pack, just as they did during the recovery phase, are the non-advanced nations. China’s economic growth rate is now slowing. As such, we expect the commodity complex to also break, and with it the relative performance of the equity markets in the commodity countries such as Canada and Australia.
26. Given current global conditions, the best economic forecast that we could make remains a steady upward-sloping “L” for the next half decade or more ... slow, slow growth. However, the probabilities of this scenario are diminishing. We have called this the BEAM scenario.
27. After long last, and just on time, the private investor had again rushed into equity markets. While a signal development, household balance sheets suggest that this phase will be weaker than in past late-market cycles.
28. That familiar amnesiac inflection point in portfolio performance is again here, when investors and clients are tempted to be unhappy with solid, steady, risk-adjusted returns ... forgetting the travails of 2002-3 and 2008-9. As such, the poor man’s “capital tax” — capital losses from inclement financial markets — could strike non-diversified

investors a little more than 2 years since the last “tax” assessment.

29. Should longer-running market contractions unfold, where to hide this time? During the cathartic equity market declines of 2003 and 2008-2009, fixed income — namely foreign fixed income — was one of the ideal places to hide besides cash. We believe that this will again be the case. Certain Asian, emerging and “safe country” bonds are attractive.
30. Do any unrepentant cash holders remain? The U.S. Fed and other advanced-nation central banks have sought to viciously punish anyone holding cash these past two years — this being the one asset that now has the best chance of offering “non correlated” returns (i.e. no losses).
31. Most major countries and regions are now dealing with their own problems. Globalism has become a distant priority. As such, the world is now in an unstable “post-globalism” period with conflicting and competing policy prescriptions. Volatility risk therefore remains above average.
32. Competition between the surplus and deficit nations for exports remains a major focus point. Currency debasement is popularly considered a better policy option than austerity. These dynamics add to cross currents.
33. We believe that consensus views are about to again shift, as has frequently occurred these past few years. The biggest shifts? We suggest the following: That commodity price rises are not driven by global economic growth expectations and demand; and that, the U.S. economy (reputed to now be in a long-term, sustainable recovery) will slow when the fiscal and monetary soothers are decreased or removed.
34. Each of the last 5 major economic downturns were preceded by energy shocks and/or major spikes in oil prices. Based on the experiences of 2008 (the last time oil prices soared), claims are made that it will require \$140 per/bbl or higher to presage the next downturn. This threshold is likely now much lower ... and already breached. The backdrop to 2011 is different. There is no euphoric consumer spending momentum driven by refi cash-outs nor the ingrained belief that higher real estate values will save the day.
35. China is now the odd “peaking” duck amongst the Asian emerging countries. It shows all the classical characteristics of a bubble economy. It depends upon an unsustainable model — mainly government real estate sales and high debt growth. China’s “bubble” economics — though the awe of Western nations — is approaching the “over-reach” fate of all bubbles. Soaring commodity prices (specifically food-related) could be the catalyst triggering an overdue deceleration (driven by a number of other factors).
36. For now, we remain under-weight to neutral on emerging markets, only holding core long-term positions in Brazil and India. Both are democracies with amongst the youngest country populations in the world. We expect emerging markets to turn up before advanced-country markets, remaining the most compelling asset sector longer-term.
37. Emerging markets, following slowdowns this year (very

possible also including hard landings), we think will represent once-in-a-decade buying opportunities. Both currencies and equity markets would be expected to deliver above-average returns over the longer-term. But not yet.

38. Balance sheet deleveraging in the U.S. household sector, the demographics of aging populations and an extreme wealth distribution skew, define the longer-term secular trends of the current era (despite recent indicators of new consumer borrowing). A further real estate price drop and a large calendar of CRE refinancings is expected to cause additional banking strains.
39. Around the globe, capital may soon again be on the search for safe assets. Mostly, these are found in smaller countries. As such, over-valuation is expected to develop in such niches ... select Asian and Scandinavian debt, and others.
40. Canada is expected to disappoint economically, though currently still an international favorite. We continue to like Canadian bonds one of the few, but small, quality bond credits in the world.
41. Hyperinflation or deflation/disinflation? Yes and no. We are not too worried that inflation will run rampant in the West. Most price rises (whether commodities or imported products) actually act as an economic depressant ... ergo, having an ultimate deflationary effect. As long as household income growth is repressed, no repeat of the 1970s is likely.
42. The biggest inflation spectre can be seen in the price for retirement. For example, a retirement portfolio in 10-year fixed-income paper must now be at least twice the size as 5 years ago to produce the same amount of income. This means that, long-term, there exists a strong impetus for higher household saving.
43. Within equity markets, we continue to prefer the securities (stocks and bonds) of large multinational corporations. The case for "big cap", high-yielding equities are best-suited to outperform bond markets over the long-term and currently represent the best relative value. Even more attractive are multinationals in the BRIC and emerging nations which have accumulated amongst the highest cash balances.
44. Gold? We continue to hold a significant overweight in gold-related assets. But we are not "gold bug" zealots. Gold bullion's lack of income at some point could prove to be an obstacle in a low interest-rate world.
45. A strong economic recovery? Just what "real economic recovery" ever in history has been marked by a shrinking

work force, low income and employment growth, and record -level food stamp usage? Such diagnostics are the marks of an economy that is deteriorating in quality. It is only financial indicators (these being largely manipulated, not the balance of real economic trends) that are reflecting the possibility of better prospects.

46. Loonie Looniness. We speak with humility on this topic, rarely having been able to call the CAD's short-term turning points. However, classical currency theory should stand us in good stead over the longterm. On that score, the CAD is over-loved and over-valued, its value distorted. Canada now has a bout of Dutch Disease. For Canadians, it remains an ideal time to buy quality, international assets.
47. Well recognized by most financial professionals is that there is no shortage of trends and developments that are unsustainable. This invites a happy diversion ... to seize trading opportunities while they last.
48. Crucially, the zeitgeist of the times is to give priority to the creation of financial wealth and "giving priority to monetary goals above goals in the real economy." To wit, historical comparatives to current policies and trends would identify the current era as being oriented to financial capitalism as opposed to production capitalism.
49. The Global Financial Crisis (GFC) is not over ... only morphing into new forms of imbalances.
50. Everywhere, ultimate reckonings are being deferred ... in Europe, the U.S., Japan and China. It is not difficult to imagine circumstances where these problems again re-emerge to the foreground, dampening currently-buoyant financial market trends.

For now, all the monetary spigots remain open, the conditions and moral imperatives in support of asset inflation (wealth effect). This indeed is the wildcard, perhaps even outweighing our 50 whys to lower risk for a while longer. However, by focusing on the balance of risks, we hope that our meanings "won't be lost or misconstrued." There indeed are at least 50 whys to leave your risk lower.

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