

Towers Perrin Q4 2009 – The Market in Review

As economic information continues to suggest that “The Great Recession” is largely over, attention is now turning to curing the hangover that must necessarily follow the explosion in government spending that was used throughout the world to keep the recession from becoming even worse. The leaders of the G7 countries are already turning their attention to how to bring government deficits back under control, but in such a way that they don’t choke off the recovery too soon. There are an increasing number of economic thinkers who, while not questioning the need to have spent the money, are very concerned that it was not spent in an economically effective manner. Brett Gallagher of Artio Global Investors suggests: “What policymakers should have been pushing for were programs that increased incomes (i.e., lowering taxes, creating self-sustaining jobs) and savings rather than providing cash for clunkers and similar programs that only served to increase debt levels.” Other commentators suggest that using the huge spending programs to provide massive infusions to banks and failing auto companies was an extraordinarily unproductive way to mortgage our future – this money would have been better spent on repairing and improving the countries’ infrastructure, a process that would significantly improve productivity for the future (particularly in the United States).

Overall debt (consumer, corporate & government) continues to be at staggering levels. Nine months of aggressive savings by U.S. consumers has had little impact on total consumer debt levels (estimated as having reduced from 97% of GDP to 95% over the period) – consumers have little chance of escaping their debt rehabilitation programs as long as global unemployment/underemployment remains in the 10-20% level. Despite this, many commentators continue to pin their hopes on the consumer (particularly in the United States) to help economies grow their way out of the current debt problem. As Bill Gross of PIMCO puts it: “Having survived due to a steady two trillion dollar plus dose of government Red Bull, the global private sector is now expected by some to detox and resume a normal cyclical schedule where animal spirits and the willingness to take risk move front and centre”. In trying to understand the potential consequences of a major deleveraging, it is useful to look to the past. A recent study by Reinhart and Rogoff titled *This Time is Different* examined eight centuries of financial crises and makes the following observations: 1) The true legacy of banking crises is greater public indebtedness, far beyond the direct headline costs of bailout packages – on average, a country’s outstanding debt nearly doubles within three years following the crisis; 2) The aftermath of banking crises is associated with an average increase of seven percentage points in the unemployment rate, which on average remains elevated for five years; 3) Once a country’s public debt exceeds 90% of its GDP, its economic growth slows by 1%. This last point has tremendous ramifications for the ability of a country to grow its way out of its debt problems – at present, a number of major countries (including the United States, Japan, Italy, France, Spain and the U.K.) are either at this debt level or are likely to be there soon. This evidence is further supported by a study by McKinsey Global Institute titled *Debt and Leveraging: The Global Credit Bubble and its Economic Consequences*.

While bond yields, in general, rose somewhat during the fourth quarter, they still remain at low levels and suggest that investors have little expectation that inflation is re-emerging in the near future. The yield on the benchmark 10 year Canada bond increased from 3.31% to 3.60% over the quarter (with most of the increase occurring in December), but has since fallen back to its September level. The yields on both Canada bonds and provincial bonds increased over the quarter, with most of the increase occurring in the middle part of the curve (5-10 year bonds). The yield on corporate bonds remained stable through the quarter, meaning that spreads again narrowed. In other markets such as the United States and the U.K., the yields on investment grade corporate bonds have continued to fall, resulting in a narrowing of spreads in those countries. The DEX Universe Bond Index posted a return of -0.2% over the quarter, with government bonds experiencing negative returns and corporate bonds posting positive returns (+1.0%). For the current plan year to date (July 1 to December 31), the DEX Universe Bond Index has posted a return of 2.5%.

Equity markets continued to rally during the fourth quarter, although on a more muted basis than we observed in the earlier part of the calendar year. The Canadian market was up 3.9% for the quarter and 14.9% for the six months since the new plan year began. The MSCI World Index was up 4.5% for the quarter and 20.0% for the six months when returns were expressed in local currency terms. However, the Canadian dollar appreciated during the fourth quarter against virtually every developed market currency, reducing the MSCI World Index return for the quarter to 1.7% for Canadian investors. In the fourth quarter, the market began to shift its emphasis from the junk stocks (levered balance sheets, troubled business models) that drove the rally during the second and third quarters of 2009 to companies with stronger fundamentals (growing earnings, strong balance sheets) – this pattern is typical of rallies following severe bear markets. During the quarter, global markets were led higher by commodity stocks (mining and energy), Information Technology stocks and consumer stocks, with all of these sectors posting local currency returns of 6% or more. Financial stocks, which were the best performing stocks during the junk phase of the rally (as government bailouts on a global basis helped them shore up their balance sheets) were the worst performing sector during the quarter, with a local currency return of -5.8%. Even Canadian Financials, which had previously been viewed favourably relative to their global peers, posted a return of -0.7% over the quarter.