GET READY
for
A CHANGED ECONOMIC LANDSCAPE

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Is the Stock Market Random and Unpredictable???
NORMAL DISTRIBUTION

• S&P 500 Returns 1926 – 2011
  mean 9.8%
  standard deviation 19.2%
• 68%, 95%, 99% of the time
• In the range of: mean +/- 1, 2 or 3 s.d.
• Extremes unusual
• Randomness means price is always right
  no such thing as a bargain
<table>
<thead>
<tr>
<th>Date</th>
<th>% Decline</th>
<th>Date</th>
<th>% Decline</th>
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<td>8.4</td>
<td>December 1, 2008</td>
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EXTREME EVENTS

more than in a normal distribution

observation more than 5 s.d. from mean
should be seen once in 7000 years.
occurs once every 3 to 4 years.

Markets have memories. Not a random event like a coin flip. Distribution has fat-tails
THE FINANCIAL CRISIS

• Was it a random event?
• Impossible to predict?
• Have we been there before?
LESSONS

• Extreme events happen frequently
• History is full of financial crises
• They follow a pattern
• Long cycles really do exist
• We are now in a vulnerable phase
NO RETURN TO NORMAL

• Lasting damage
• Slow/protracted recovery
• Government finances disrupted
• Slow recoveries mean more debt
• Larger than the recession’s bailouts
• New forces: Debt and Balance Sheets
CHANGED RISK PREMIUMS

• Two extremes – very low to very high
• Debt minimization primary goal
• Trumps profit maximization
• Debt financing involves risk
• Shift towards equity financing
• Changed capital structure
• Less leverage – slower growth
A LONG CYCLE

- Nikolai Kondratieff, Reinhart & Rogoff
- Forecasting models don’t work
- Need a much longer/wider data set
- The “Big Five”
- Long-term fiscal restraint ahead
- Slowest U.S. recovery since WW-2
LOOKING ACROSS CYCLES

- Now 4 years since recession began
- Below the range of all cycles since 1948
- Now in line with the Big Five
- A repeat of that pattern
- More of the same the next 2 years
- Still weaker than any post-1948 cycle
- Europe doing even worse
- Even below Big Five pattern
2013 A DANGEROUS YEAR

• Urgent priorities
• U.S. fiscal drag…1% this year
• More coming…… 2-1/2% in 2013
• Stimulus from 2009 Recovery Act gone
• Last year’s debt ceiling agreement
• Bush tax cuts expire
• Payroll tax reductions expire
• A U.S. stall-out in 2013?
DON’T BE TOO PESSIMISTIC ON U.S.

• Replacement cycle
• Bank stress test results
• Housing recovery
• Job growth
• Return of outsourced jobs
• Household finances
• Manufacturing
UNITED STATES
MOTOR VEHICLE SALES

Millions of Units

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HOUSEHOLD DEBT

Debt Service Ratio (DSR)
Ratio of debt payments (required payments on outstanding mortgage and consumer debt) to disposable personal income.

Financial Obligations Ratio (FOR)
Adds automobile lease payments, rental payments on tenant-occupied property, homeowners’ insurance and property tax payments.
UNITED STATES
CORPORATE PROFITS AS SHARE OF GDP

Average 9.1%
PROFIT MARGINS

• Historical high
• Well above long-term average
• Is this sustainable?
• Typically cyclical. “Mean reverting”
• Limit to cost-cutting
• Unit labour cost turnaround
• Demand growth limited (debt/deleveraging)
WHERE IS CANADA NOW?

• This Year
  - uncompetitive, slow growth

• 2013
  - fiscal drag, slow growth

• 2015
  - higher rates, higher inflation
  - a time to hedge
NEW FORCES SHAPING CANADA

• Household deleveraging will appear
• Debt servicing costs will increase
• Saving rate will have to increase
• Public debt will require attention
  - 83.5% of GDP (69.4% in U.S.)
• Bank of Canada rate increases
• A shift in export focus to Asia
EUROPE

• Outcome hinges on Italy/Spain
• Italy world’s 3rd largest debt
• Massive refinancing in 2012
• Will the roll-overs be successful?
• Years of austerity/credit squeeze
CAN THE EURO SURVIVE?

• Different scenarios
• Political will…Austerity
• A long workout. Plenty of risk.
• Temptation for some to leave
• Devaluation/inflation outcome
• Banking crisis would intensify
GERMANY

• Export model problem: big imbalances
• Huge current account surplus
• Larger than China’s
• +4.9% of GDP vs. +2.1% for China

• Italy: -2.7% deficit
• Spain: -2.9% deficit
• France: -2.1% deficit
DOWNSIDE RISK IN EUROPE

- Emerges from recession this year?
- Fiscal austerity/bank deleveraging
- Euro banks continue to tighten
- Impact on Emerging Europe, Asia
- Political ability to meet promises?
THE ECB HAS ONLY BOUGHT TIME

- Liquidity program will run its course
- Markets will run into trouble again
- Euro banks will have to raise much more capital
- Necessary to restore wholesale funding
- Interbank funding outflows
- Contraction in bank loans (Spain, Italy)
SURPRISES/OPPORTUNITIES

• Crisis > permanent change
• Long-term trends accelerate
• Heavier impact on some regions
  - Older manufacturing regions
  - Sun Belt (real-estate, fictitious wealth)
• Creative hubs the winners
  - Boston/NYC/D.C, Charlotte/Atlanta, Chicago
  - Scientists/engineers/managers/ professionals
MODERN SHALE GAS

- A game-changer - 116 years supply
- Transformative technology
- Lower 48 - OH, PA, MI, NY, MA, TX, LA
- Very green on a fully burdened basis
- Economics spectacular
- Don’t need electric cars
- Off coal to natural gas for base-load
- U.S. an exporter of LNG
- Good news for manufacturing
U.S. HEAVY TRUCK FLEET

Switch to Compressed Natural Gas

U.S. crude oil imports $1 billion/day

½ used by heavy trucks

Simple logistics for truck refueling

Same routes, regular schedules

Only 8 million heavy duty trucks
250 million passenger cars
ENERGY OPPORTUNITIES

• Alaskan LNG Exports to Asia
• Louisiana LNG export terminal
• Gulf deep-water drilling
  - 2,000 feet or deeper
  - Perdido well 9,625 ft. below
  - “world’s best place to drill”
MARKETS HAVE MEMORIES

• Be a stock picker
• Be a market timer
• Use technical analysis
• Use fundamental analysis
• Use a full service broker
IF YOU BELIEVE IN RANDOMNESS

Minimize costs
Minimize taxes
Asset allocation

A buy and hold investor.
Low cost mutual funds or ETF's
MID-1929?

Buy and hold?

A long wait

1955