

Global debt hangover

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The 2011 economic year ended on a fragile note owing to the sovereign debt crisis, which had repercussions on all financial markets to the point of overshadowing other economic and political problems elsewhere in the world. Now that the risks have been identified, will we see any solutions materialize in 2012?

The sovereign debt crisis continues to present the main risk to world economic growth in 2012. If European authorities and the European Central Bank cannot agree on a solution, the world financial system as a whole could be affected. One fact is clear: the current structure of the euro zone is not working and the stubbornness of politicians in the efforts to save it has caused more harm than good. The current status quo is only making financial markets nervous. Finding a solution that all euro zone countries, including Greece, will agree on is far from evident.

The worst scenario would be for each country to go back to its local currency and to its own central bank—in other words, a dismantling of

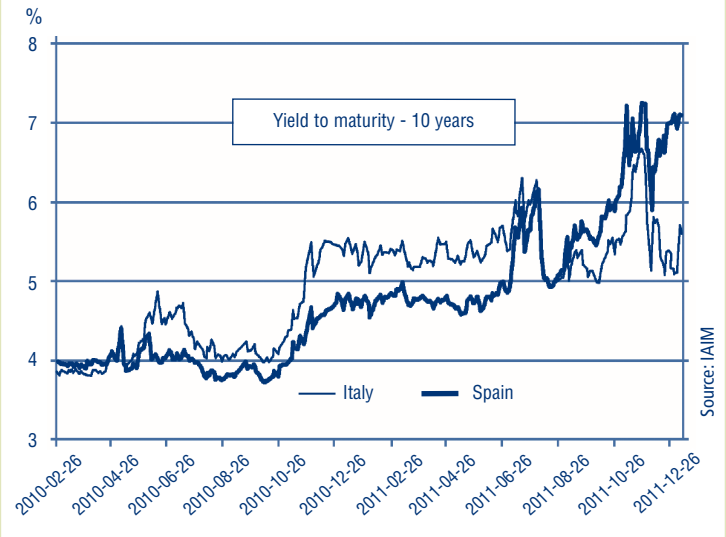
the euro zone. That would cause pure chaos on the financial markets. But in December, euro zone countries gave themselves a last chance to find some kind of solution. The agreement reached by 26 of the European Union's 27 members strengthens the budgetary union among these countries considerably. For example, each member state must make sure that its structural deficits do not exceed 0.5% of its GDP. As well, automatic sanctions will be applied against any state whose public deficits exceed the ceiling of 3% of GDP, unless a majority of members are opposed. While this is certainly a step in the right direction, how it will unfold in practice remains to be seen.

The first test will be Greece. The country could default on its bonds in March: it therefore has until that time to reach an agreement with its international lenders on its second bailout of 130 billion euros. The Greek government has begun a race against the clock to reach an agreement with the European Union, the International Monetary Fund and private banks on the terms of the plan

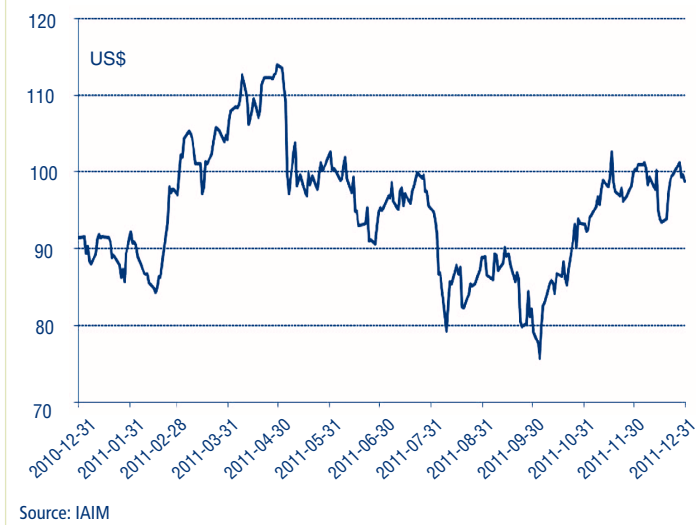
presented in early December. If Athens fails, according to the new rules, it will have to leave the euro zone. To win this race, the Greek government will have to apply additional austerity measures such as further raising income taxes, cutting civil servants' salaries, and reducing the number of employees in the public sector. All this to reduce public spending and regain confidence of the financial markets, confidence which was severely eroded over the last year. This erosion has translated into higher and higher interest rates to finance the Greek debt. That is the price to pay to keep Greece in the euro.

While Greece may be the first test, Italy and Spain will be a test in themselves given the size of their respective debts. Investors have indicated their fears by also requiring increases in borrowing costs over the last year (see graph 1). Meanwhile, the credit rating agency Standard & Poor's announced that it was putting 15 euro zone countries on its negative outlook watch list, including France, Germany, Italy and Spain. Should the sovereign debt holdings of private banks be downgraded, these banks would

Graph 1 - Evolution of 10-year bond rates for 2010-2011



Graph 2 - Evolution of the price per barrel of oil in 2011



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require an injection of funds from governments to maintain their capital ratios. This would further increase public debt and amplify the risk of government default. None of this is very reassuring.

The solution must come from authorities such as the International Monetary Fund (IMF) and the European Central Bank (ECB), which must show their will to intervene in countries threatened by default; in return, these countries must demonstrate their resolve to clean up their financial situations. Historically, a number of countries have defaulted in the past, such as Russia (1998), Argentina (2002), and Mexico (1982). Before a country throws in the towel, credit rating agencies send them a warning to restore their public finances. For example, Denmark, Finland and Sweden were all downgraded by the rating agencies in the 1980s and 90s because of their massive debts and out-of-control public spending. The three countries then embarked on deep structural reforms, allowing them not only to regain their "AAA" ratings but also to reduce their public debts at a time when those of the G7 countries were growing.

Therefore, now that the causes of the sovereign debt crisis are known, the next step is to implement solutions that will be difficult to adopt but that are essential for the survival of the euro zone as we know it. If not, then the face of the euro zone could change drastically in the coming years, to the point of losing the weakest links among its current 17 members.

Aside from the European crisis, let us not forget the other economic and political problems that still pose a threat to the world economy in 2012. In the United States, after tottering for the first nine months on the brink of a "double dip" recession, it seems that the economy is gaining momentum and that the job market is slowly gaining strength, showing positive job creation from month to month. Moreover, the balance sheets of U.S. companies are indicative of sound financial health, which bodes well for maintaining current jobs as well as for hiring. However, several risk factors could still derail the U.S. economy. First, given the globalization of financial markets, a liquidity crisis in Europe could affect

the U.S. banking system. Second, the real estate market has still not recovered from its collapse in 2008. Third, the political squabbling between democrats and republicans is not conducive to creating a favourable environment for economic improvement, and next November's presidential elections

Chart 1 - Returns of the Canadian Bond Market as at December 31, 2011

Index	Returns (%)	
	3 months	YTD
DEX Universe Bond Index	2.1	9.7
DEX Short Term Bond Index	0.5	4.7
DEX Mid Term Bond Index	2.0	10.9
DEX Long Term Bond Index	4.9	18.1
DEX Canada	1.4	8.4
DEX Provincial	3.7	13.2
DEX Municipal	2.7	11.6
DEX Corporate	1.6	8.2

Source: Scotia Capital Debt Market Indices

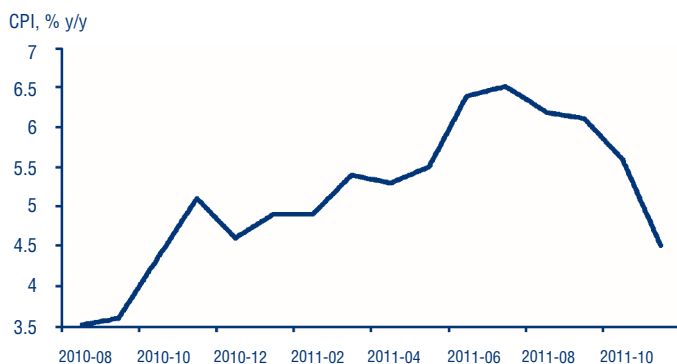
will have a direct impact on the direction the U.S. takes on economic reforms.

Uprisings in the Arab world may continue. On the heels of Tunisia, Egypt, Libya and Yemen, it is now Syria's turn to make headlines. The current regime is attempting to suppress by any means the rebellion that has already resulted in some 5,000 deaths by the UN's count. Other Arab countries could see uprisings as well in 2012.

As for the price of oil, several factors have played a role in its increase since mid-November. These have included a series of better-than-expected economic indicators in the U.S., problems in the Arab countries, and Iran's threat to close the Strait of Hormuz—a strategic oil shipping lane and transit point for about one fifth of the world's oil supply (Graph 2).

Emerging regions such as China are also affected by the world economic situation. Chinese exports are down sharply. In addition, restrictive measures aiming to curb real estate speculation in China and to contain inflation have borne fruit, as prices in the real estate sector and the level of inflation have dropped in the last few months (Graph 3). To counterbalance its weak exports, China has lowered the capital requirements of its commercial banks in order to stimu-

Graph 3 - Inflation down (CHINA)
(A clear trend of loosening of the Chinese monetary policy)



Source: Macquarie Research, December 2011

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late domestic growth and maintain its overall rate of economic growth.

FINANCIAL MARKETS

The stock and bond markets moved in opposite directions throughout the year. The first months of 2011 were characterized by a certain amount of optimism, translating into positive returns on the stock markets at the end of the first quarter, while the Canadian bond market posted a slightly negative return given the rise in the interest rate curve.

Then, the wave of enthusiasm vanished after a series of both economic and political upheavals. Fears of sliding back into recession in the United States, the Japanese tsunami, the Arab spring, the downgrading of U.S. treasury bonds by Standard & Poor's as a result of the U.S. public deficit, and the interminable saga of the sovereign debt crisis in Europe sustained investor uncertainty throughout the year.

While Canadian and U.S. bond rates reached historic lows, European rates hit record levels amid fears of the inability of a large number of countries to finance their sovereign debts and gloomy economic outlooks. For some European coun-

tries, overly high debt-to-GDP ratios and a very real risk of default caused investors to demand even higher rates. The fact that many European banks have these securities on their balance sheets makes financing even more difficult. With the spectre of recession looming in

Europe, unsustainable borrowing costs for some countries and, especially, the inability of the most indebted countries to devalue their currency, investor confidence in Europe has tumbled.

Faced with this sharp deterioration of the economic and financial environment, the European Central Bank has had to intervene by lowering its key rate from 1.5% to 1.0% since the fall. It also supplied liquidity to the European banking sector and began a bond-buying program for countries in difficulty, aiming to reduce the borrowing rates of countries such as Italy, Spain and Greece.

Stock markets have behaved according to investor mood. Although 2011 took off in a climate of relative optimism, negative news from around the world and intensifying of the European crisis caused the financial markets to shiver.

Chart 2 - Market Returns as at December 31, 2011

Index	Returns (%)	
	3 months	YTD
DEX 91 day Tbill Index	0.2	1.0
DEX Universe Bond Index	2.1	9.7
S&P/TSX Composite Index	3.6	(8.7)
S&P 500 (Can. \$)	9.5	4.4
MSCI - EAFE (Can. \$)	1.2	(10.2)
MSCI - World (Can. \$)	5.3	(3.4)
Exchange Rate (Can. \$ / US \$)	(2.1)	2.3

Canadian investors, translating the return into 4.4% in Canadian dollars.

The Canadian stock market, represented by the S&P/TSX composite index, posted a year-end return of -8.7%. Given that raw materials prices were down in 2011 and that nearly 50% of the Canadian index is made up of stocks related to natural resources, this poor performance is not surprising. Cyclical sectors such as energy, materials, consumer discretionary and technology delivered the worst returns, with -9.9%, -21.2%, -15.5% and -52.5% respectively. Defensive sectors such as consumer staples, telecommunications and utilities posted returns of 6.8%, 24.9% and 6.5% respectively.

Outside of North America, the European market was of course badly affected. The MSCI Europe Index recorded a drop of 8.5% for the year, in Canadian dollars. The MSCI World Index ended the year down 3.4% in Canadian dollars. As for the MSCI EAFE, it ended the year down 10.2% in Canadian dollar terms.

The winner of the year was the bond market, which benefited from the uncertainty emanating from Europe. To compensate for the uncertainty of the stock markets, investors sought to place their assets in safe havens, such as U.S. and Canadian bonds. Bond rates of these two countries therefore dropped dramatically during the year, pushing up bond returns. Thus, the DEX

Chart 3 - Market Returns as at December 31, 2011

Index	Total Return	
	3 months	YTD
S&P/TSX Sector returns		
Energy	11.4	(9.9)
Materials	(4.3)	(21.2)
Industrials	15.1	4.2
Consumer Discretionary	0.5	(15.5)
Consumer Staples	2.9	6.8
Health Care	14.9	50.4
Financials	1.2	(2.9)
Information Technology	(15.5)	(52.5)
Telecommunication Services	9.9	24.9
Utilities	0.9	6.5
S&P/TSX Composite Index	3.6	(8.7)

All stock market indices of the industrialized countries posted negative returns, except for the U.S. S&P 500. The latter was up from the other indices, ending the year with a slightly positive return of 2.1% in local currency, but this time the depreciation of the Canadian dollar (more than 2%) was a benefit to

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Universe Bond Index ended the year up 9.7%. In terms of issuers, provincial bonds offered the best performance, with 13.2%, followed by federal bonds at 8.4% and corporate bonds at 8.2%. With respect to terms to maturity, given the decline in the yield curve, long-term bonds (10 years or more) offered the spectacular performance of 18.1%, followed by medium-term bonds and short-term bonds, which posted returns of 10.9% and 4.7% respectively.

Chart 4 - Economic and Financial Indicators - Canada

	2006	2007	2008	2009	2010	The most recent data	Trend	Forecast December 2012	
Real gross domestic product (%)	2.7	2.4	0.3	-2.6	3.2	2.7 ¹	→	1.90 to 2.10	*
Inflation rate (%)	2.0	2.5	2.4	1.3	2.0	2.9 ²	→	1.95 to 2.05	*
Unemployment rate (%)	6.3	5.9	6.5	8.5	7.6	7.4 ²	→	7.15 to 7.25	**
DEX 91 day Tbill Index (%)	4.01	3.9	0.87	0.21	0.98	0.79 ³	→	1.0 to 1.25	**
3-year mortgages (%)	6.2	7.55	6.25	4.25	4.15	4.05 ³	→	4.75 to 5.0	**
10-year bonds (%)	4.4	4.0	2.68	3.61	3.12	1.94 ³	→	2.65 to 2.80	**

¹ As at October 31, 2011- ² As at November 30, 2011 ³ As at December 31, 2011
* Annual average ** End of period

OUTLOOK

Central banks will have an even greater role to play in 2012, with Europe's financial instability being their primary preoccupation. The traditional tools that central banks and government have used in the past, such as lowering interest rates and increasing public spending, will be obsolete. We can expect new quantitative measures in 2012.

Economic history tells us that the solution to the current sovereign debt problem is simple: reduce public spending and increase tax revenues. But will today's politicians have the courage to do so?

Yet there is a third, less painful solution that would resolve the debt problem: inflation. A return to inflation would translate into an increase in prices, revenues and gross domestic product, which would reduce the relative weight of the debt. The losers would be the creditors who lent at fixed rates. For example, when prices rise by

8% and the interest rate of a loan is 2%, the lender loses 6% each year on what he has lent. Meanwhile, the borrower sees his debt load get 6% lighter each year in terms of purchasing power.

2012 will be interesting on the economic front, because there will be heavy discussions between the countries in debt, the countries with debt surpluses, and the central banks, as they try to determine what approach to follow to resolve the debt problem.

In the next 12 months, we expect a slight increase in the interest rate curve. This increase will have an impact on the bond market, given the inverse relationship between interest rates and bond prices. Thus, we expect the total bond return to be weak. If we combine the average coupon of 4.55% with the "capital gain" portion (see table 5), the total return should be around 0%. We are therefore of the opinion that

bond returns will be rather modest for the next 12 months. However, we are more optimistic about the potential return of equities. For Canadian equities, we are forecasting a return of about 15% for the next 12 months, dividends included.

Given this perspective, we have maintained our asset distribution of the last quarter—that is, underweight in bonds and overweight in equities. The asset distribution is reviewed periodically according to the latest economic data in order to take advantage of any investment opportunities that may present themselves.

Chart 5 - Estimated Gross Returns for the Next Twelve Months Starting December 31, 2011

Market indicators	Interest or dividend	+	capital gains	=	Total estimated gross return
DEX 91 day Tbill Index	1.00%	+	0.00%	=	1.00%
DEX Universe Bond Index	4.55%	-	(4.85%)	=	(0.30%)
Canadian stocks (S&P/TSX Composite Index) including dividends	----->				15% to 25%