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Thoughts from the Club X Investment Conference

Cambridge, Ontario May 13 to 14, 2009

The backdrop for the 6th annual Club X Family Office Investment Conference was the 30 to 40% rally in global equity markets, tentative signs of a stabilizing economy, weakness in the U.S. Treasury bond market and a sharp pullback in the U.S. dollar. The key issues at the conference were the sustainability of the economic recovery and stock market rally, the consequences of unprecedented monetary easing, and the massive blowout in the U.S. fiscal deficit.

David Rosenberg, who recently joined Gluskin Sheff from Merrill Lynch, NY, and Chen Zhao of BCA Research, provided a broad overview of current macroeconomic conditions. Both highlighted the massive rise in U.S. household debt to GDP over the last 20 years, and estimated that a reduction in household debt of approximately U.S. $3 trillion would be necessary through dramatic changes in consumer behaviour. The U.S. household savings rate fell from a long-term average of 11.4% prior to 1985 to close to zero recently. This trend has recently reversed with a vengeance, and higher savings rates will likely persist for years to come.

Rosenberg spent some time discussing issues related to the baby boomers, now on average 52 years old. As he put it, “Boomers are visiting their financial planners and seeing two numbers that scare them: mortality tables and their retirement portfolio.” After having lost 20%

of their net worth and with real estate contributing nearly one third of household assets, boomers are the only age group showing employment increases over the last year. Boomers will show a large and persistent increase in their savings rate, and their need for income will make corporate bonds and dividend paying stocks attractive investments. Rosenberg asserts that a fundamental shift has occurred that will prevent the U.S. from returning to pre-crisis growth rates.

Chen shared this view on excess household debt, but was somewhat more optimistic about a recovery. He recommended investors be relatively aggressive, pointed to some early signs of economic recovery, including relative strength in emerging markets, an uptick in retail sales and the Institute of Supply Management (ISM) index, as well as strength in industrial commodities. Most promising, the U.S. economy is showing rapid signs of adjustment. He pointed out that in the 1930s; the U.S. had a flexible economy and rigid monetary system while Japan in the 1990s had a rigid economy but flexible (i.e. expansionary) monetary policy. Chen argued that rigidity, whether in the economy or monetary policy, is a precondition for protracted weakness in a debt deflation. In contrast to those earlier periods, the U.S. has both a flexible economy and monetary policy and, therefore, should recover much more quickly.

Looking at previous recessions, markets rally on average six to nine months before the economy turns around. Waiting for confirmation from economic data would have caused investors to miss out on these early gains, which are often some of the steepest. Chen thought that government intervention and attempts to reflate will ultimately be successful. However, he also cautioned that the deteriorating U.S. fiscal position could provide the impetus for another shock to financial markets in two to three years.

Both Chen and Rosenberg saw the best opportunities resulting from a recovery in emerging Asia, and in industrial commodities and the countries that produce them.

Real Estate

Joe Gyourko, a professor of real estate at Wharton and a well known industry consultant, provided a detailed look at the U.S. real estate market. He defines two general types of housing markets: those elastically supplied, “sunbelt” and other central state markets, and supply constrained coastal markets. Regarding the former group, his analysis of the gap between price to minimum profitable production cost indicates that many of the frothiest markets have already adjusted substantially and may be at or close to a bottom. On the other hand, prices in the coastal markets are determined by demand rather than production costs, indicating that prices will fall until the labour market stabilizes – probably not until 2010. In places like Miami, which had become very over-priced and sold off dramatically, new demand from Europe, South America and snow birds could come into play to stabilize the market in the next year or so. In general, a significant bounce back in housing prices in the near term is unlikely. Rather, a prolonged period of consolidation and weak demand for homeownership is likely.

A huge problem is that lending standards have tightened enormously. The sub-prime loan is probably gone forever and typically, the average mortgage lender now wants a 20% down payment. Since the average home sells for $200,000 to $225,000, this requires a $40,000 to $45,000 down payment. Since the median liquid net worth of Americans is $7,500, home purchase is way beyond the reach of many without years of saving.

Professor Gyourko advised keeping a close eye on the commercial real estate market, as it looks like an approaching train wreck. The last U.S. Commercial Mortgage Backed Security (CMBS) issuance was in June 2008 and spreads have blown out since November 2008 on very low volume. Accounting for leverage and 25 – 30% decline in property values, equity in many REITs and among other holders of leveraged real estate could be wiped out. U.S. $1.2 trillion of commercial real estate debt is rolling over through 2011, indicating a prolonged financing challenge for the industry. Ultimately, CMBS could be a new source of hemorrhaging on bank balance sheets, sparking a fresh wave of write-downs. Several days after Professor Gyourko's talk, a 40-storey Manhattan skyscraper, the 1330 Avenue of the Americas building sold for U.S. $100,000, down from $500 million three years ago on condition the buyer assume the outstanding debt on the building. This is just the latest of a series of prime office towers selling at dramatic discounts.

Asset Allocation

Several hedge fund managers, including Barry Allan of Marret Asset Management and Albert Friedberg of the Friedberg Global Macro Hedge Fund, provided their view of the markets. None were bullish on equity markets.

In terms of credit markets, several speakers believed Treasuries are grossly overvalued and had taken short positions. Corporate debt is seen as an attractive sector with spreads still very high in spite of considerable narrowing in recent months. Allan cautioned that this cycle may follow a markedly different pattern than previous ones due to the ongoing financial crisis. Significant increases in bankruptcy rates will likely make high yield a challenging and volatile sector over the next few years.

Energy experts Henry Cohen (Full Cycle Investment Management), Scott Gill (Energy Opportunities Capital Management), and Dr. Herman Franssen (International Energy Associates), provided a compelling view of the energy sector both as an inflation hedge and due to medium term supply shortages resulting from the current period of underinvestment in the sector.

David Abramson of BCA Research focused on commodities, arguing that dollar weakness against an increasing basket of currencies would lead to a renewed up-leg in commodity prices. In particular, he favoured the commodity-linked currencies of Canada and Australia versus the U.S. dollar.

Reflecting a widely held perspective on gold, Al Friedberg argued that as a consequence of the "monetary debauchery" taking place virtually around the world, people would see a much higher price for gold in the next two to three years. While normally such a consistency of opinion is a cause for concern, occasionally the consensus is right, at least until the late stages of a market move.

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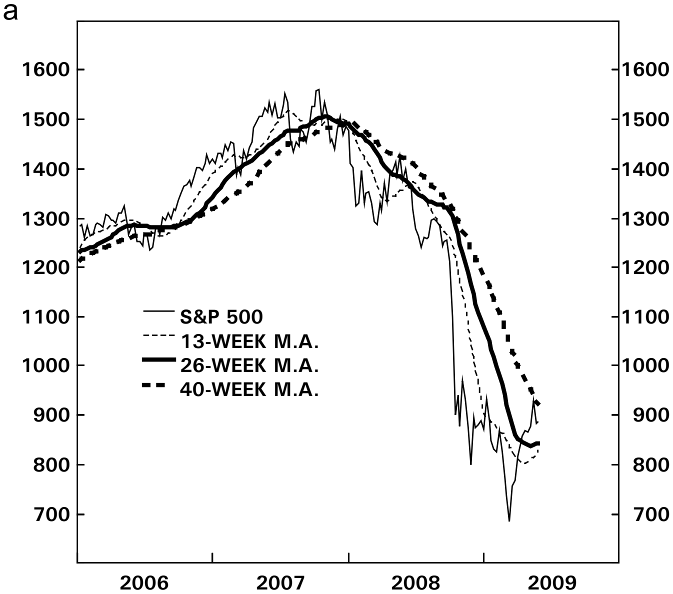
Investment Conclusions

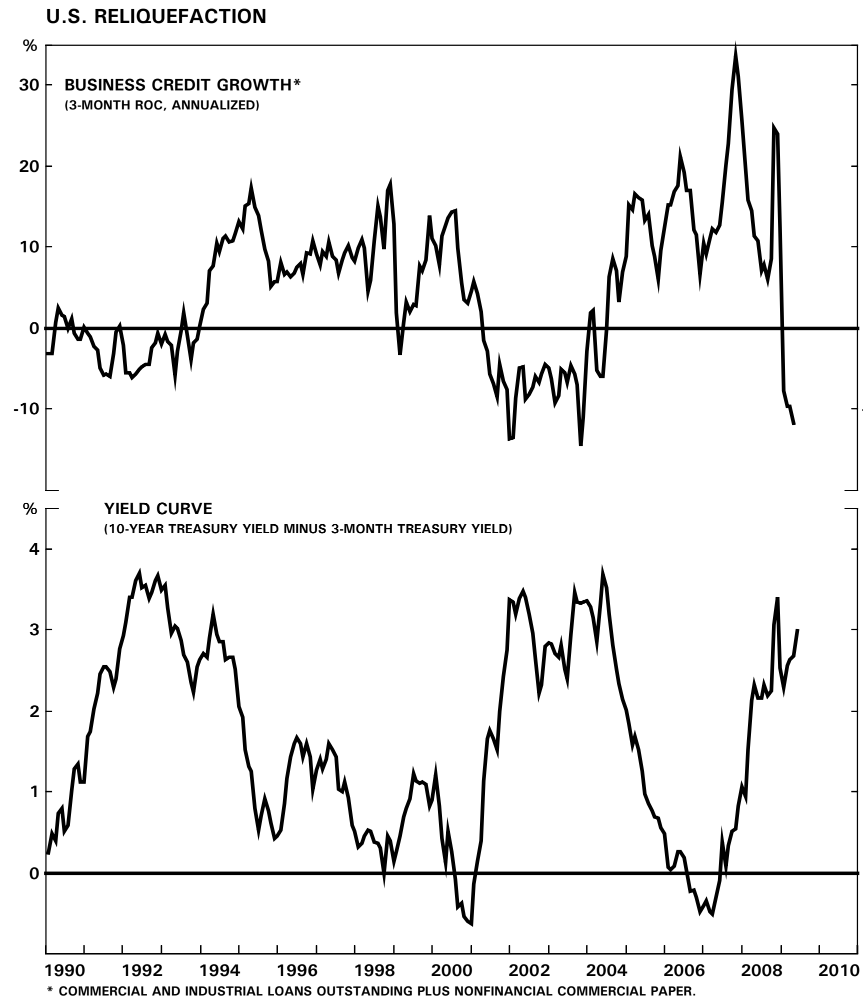
The conference certainly stimulated a lot of discussion on controversial points. My *(Tony Boeckh)* take on the markets, as outlined in my talk and recent investment letters, is that we are in the sweet spot for equities and high yield bonds. The U.S. authorities have aborted a potential debt deflation from the banking and housing collapse.

S&P 500

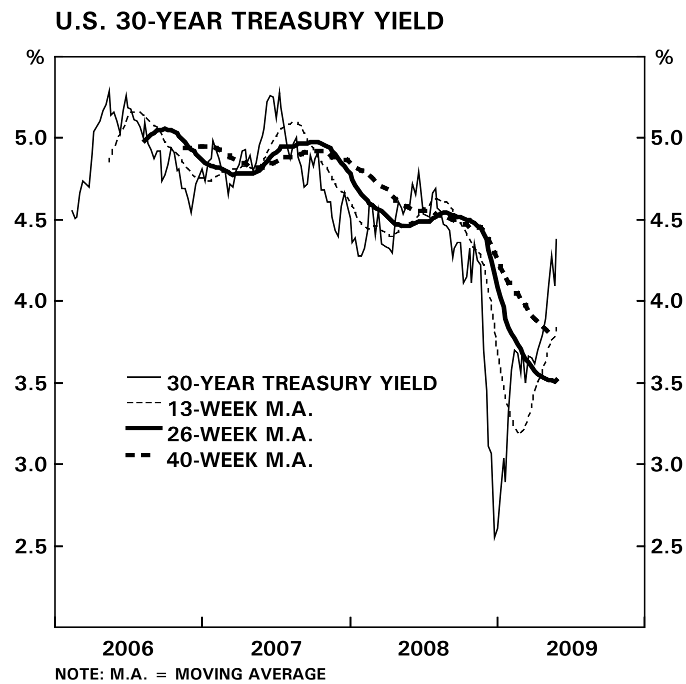


NOTE: M.A. = MOVING AVERAGE

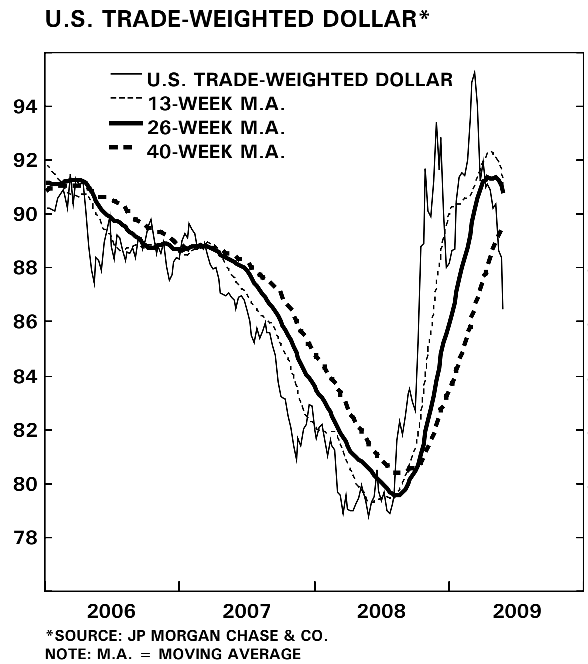
This has taken a huge amount of risk out of the system. The wall of money pumped into the system is hitting an economy that is deleveraging and has a pricing structure that is between disinflationary and mildly deflationary. Cyclically, this is the most bullish time for equities. The market is up roughly 30 – 35% from the very depressed lows and will probably consolidate for awhile, but higher levels are likely. Renewed inflationary pressure may be inevitable but a very weak household sector, as Rosenberg emphasized, will keep the economic recovery soft and hold price inflation in check for some time.



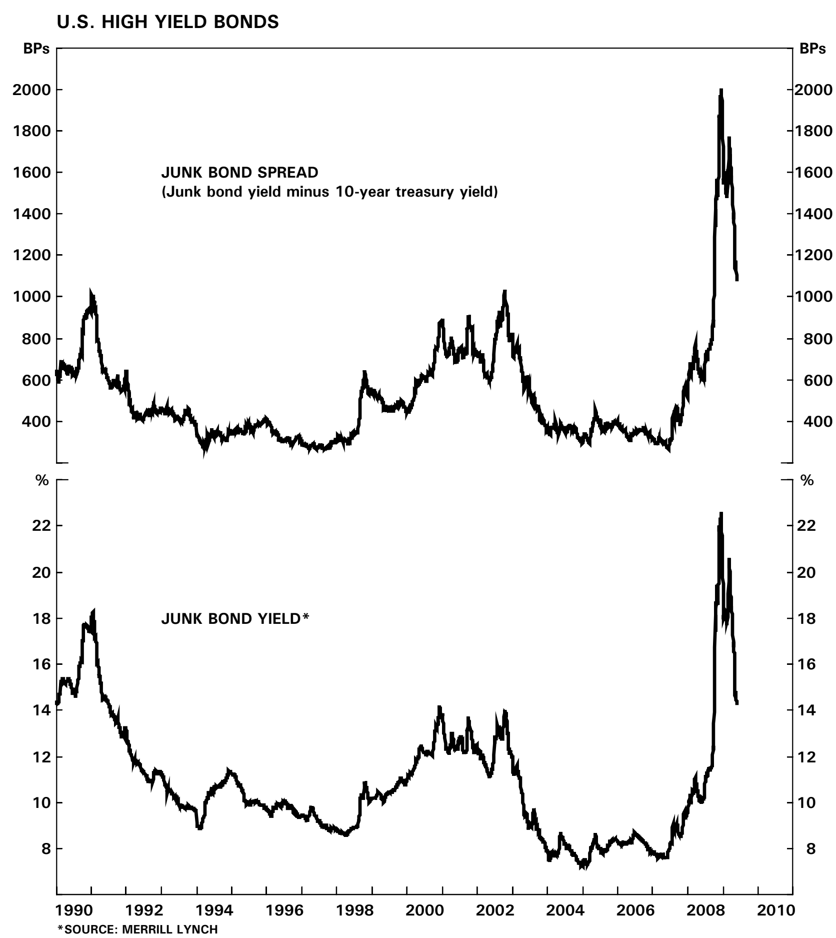
The big concerns are two-fold: the U.S. Treasury market and the U.S. dollar. The 30-year Treasury yield has risen from 2½ % at the end of 2008 to almost 4½%, already a major bear market. However, yields are still not back to the pre-Lehman level. Treasuries, as indicated by the 10-year bond and the valuation index are still very expensive. Investors in highest quality bonds should have very short duration. Treasury bonds are also suffering from the migration of investors to higher yielding assets and the worry over funding gigantic Treasury deficits.

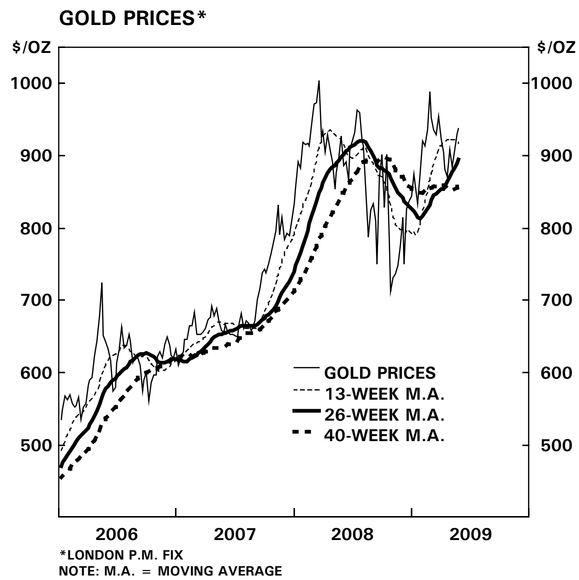


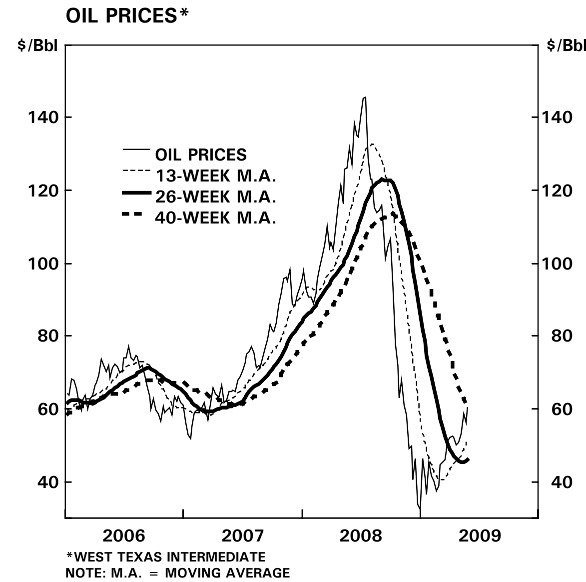
The second major concern is the U.S. dollar. The trade-weighted index has dropped over 10% since the crisis high and this is also disturbing for the Treasury market. Investors should continue to bet on a lower dollar with a risk of a dollar crisis down the road.



High yield spreads have collapsed with the fading of the crisis. As the chart shows, the Merrill Lynch Junk spread over Treasuries has fallen from about 2000 basis points to slightly over 1100. This is still higher than the last two peaks. Above average returns on these bonds will be available, but, as Barry Allan pointed out, there will be lots of volatility.







The gold market has performed well in recent weeks but the bullish consensus at the conference (and everywhere it seems), is a bit disconcerting. The wall of money creation and potential inflation are very positive for gold longer-run, but with so many bulls around, there may be some consolidation in the shorter-run.

The oil price has also been strong recently, breaking out marginally to a recovery high. But there is some fraying in OPEC discipline as cheating is picking up and many oil producers are in a weak financial position. Some additional supply could find its way onto a market with huge inventories and demand which is still being downgraded by the IEA. We would be cautious on oil in the short-term, while remaining bullish longer-term.

Tony Boeckh　　　　　　　　　　　　　　　　　　　　　Rob Boeckh

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