



# From The Desk

Observations, thoughts and theories from the world of global portfolio management.

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### Issues Facing Today's Investor

As inflation fears move onto the front page alongside the financial crisis stemming from the sub-prime aftermath, we are confronted by the conundrum facing North American Central Banks. How can the Fed stave off a financial collapse while maintaining price stability? The solution they have arrived at is to deal with the expanding financial crisis now, reasoning that they can deal with inflation later. For those of us old enough to remember how difficult the inflation fight was during the late 1970's and early 1980's, as the Canadian and US central banks relentlessly ratcheted up rates in an attempt to contain inflation, you can excuse us for getting a slight knot in our stomachs. Once the inflation genie is out of the bottle, can you put it back in?

Complicating matters in North America is that the Bank of Canada and the Federal Reserve face very different problems, yet our economies are inextricably linked. The largely commodity-based Canadian economy is adjusting to a strong dollar that is causing problems in the manufacturing sector that threaten to spill over to other sectors. Inflation in Canada, as measured by CPI, is still within acceptable bounds (i.e. most recently 1.4%, well below the 3% upper band), so the Bank of Canada has room to reduce rates, in an effort to pace the Fed's cuts and stimulate growth. The ongoing cuts (most recently by 0.5% to 3.5%) will also serve to lessen, or at least not add to, the upside pressure on the Canadian Dollar.



Meanwhile, south of the border, the Federal Reserve continues to cut for very different reasons and has decided to risk inflation. With the US banking system and the cause for its crisis, the US housing market, both in turmoil, Ben Bernanke has clearly signaled that the Fed's intention is to drive rates down and they likely to approach their post 9/11 lows. In the face of the spreading financial crisis, the Fed has little alternative. The lower rates will allow adjustable rate mortgages to reset at more digestible levels for the US consumer, while spending from financial and industrial concerns should experience an up-tick. Of course, lowering rates has the undesirable effect of further weakening the US dollar and we know that no country in history has devalued its way to greater prosperity. Perhaps the US will experience some offset from the positive impact of a weak dollar on their trade imbalance, but that outcome comes with a long lag and is far from being a certainty.

Taking the constructive view, by assuming the US is able to weather the current crisis under Bernanke's stewardship, when does the recovery begin? As the US emerges from the financial crisis, they will most likely be facing an inflation crisis that will force the Fed into aggressive rate hikes. Since inflation effects are typically not shown in CPI numbers for several months, the Fed will be in the unenviable position of using a leading tool to fight a lagging number. When the only tool you have in your toolbox is a hammer, every problem looks like a nail.

The most resilient economy on the planet is likely to experience some turbulence through this cycle, the outlook is not entirely bleak. With lower rates and repaired balance sheets – both governmental and banks – the market move will likely outpace the economic upside by a considerable margin. Having weathered the bulk of the correction, capitulation selling here may be both late and wrong.