Investment Commentary

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Recovery Denial Syndrome

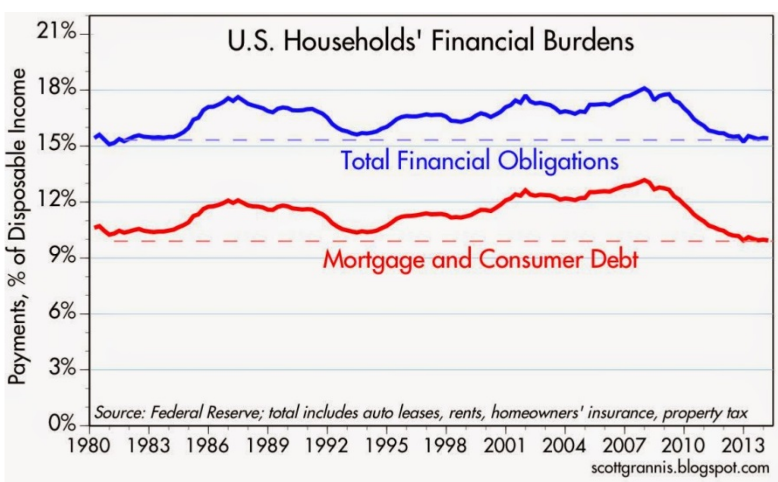
It has been quite unfashionable to admit that the Great Recession ended a while ago – formally five years ago in June, 2009. It seems we have effectively been in a state of *Recovery Denial Syndrome (RDS)*. To varying degrees, RDS has infected even our nation's most prominent economists – not excluding the Chairwoman of the Federal Reserve (the Fed) who recently described the pick-up in economic activity and price levels this way: "the recent evidence that we've seen, abstracting from the noise, suggests that we are moving back gradually, over time, toward our 2% [inflation] objective." This reflects the Fed's current view that economic activity remains muted, price levels are well under control, and the Fed's current zero-interest-rate policy will remain intact.

The primary reasons this five year recovery has felt slow and painful are:

1. Consumer debt reached historically high levels – so saving more (and spending less) in order to pay off debts (deleveraging) makes for slower recoveries;
2. Peak unemployment reached a wincing 10% back in late 2009 – and has been slow to recover;
3. The initial 50% market decline, bank closures, and general doubt regarding financial stability has led many to be quite cautious from an asset allocation standpoint.

Despite five years of actual economic recovery, we collectively hang our heads. What then will snap us from this funk? Generally speaking, a solid pick-up in economic growth will do the trick. In our view, this will occur following a reversal in the factors listed above. The good news is that all three of these have indeed reversed - leading us to believe that higher levels of economic growth reside on the near-term horizon.

Financial Burdens are back to historically reasonable levels



Employment numbers are recovering – slowly, but surely

The stock market is at all-time highs

In aggregate, consumers make up approximately 70% of our economy. With more people working, less people burdened by debt, and more people with higher levels of household wealth, consumers are poised to re-engage their animal spirits.

Winter is Coming

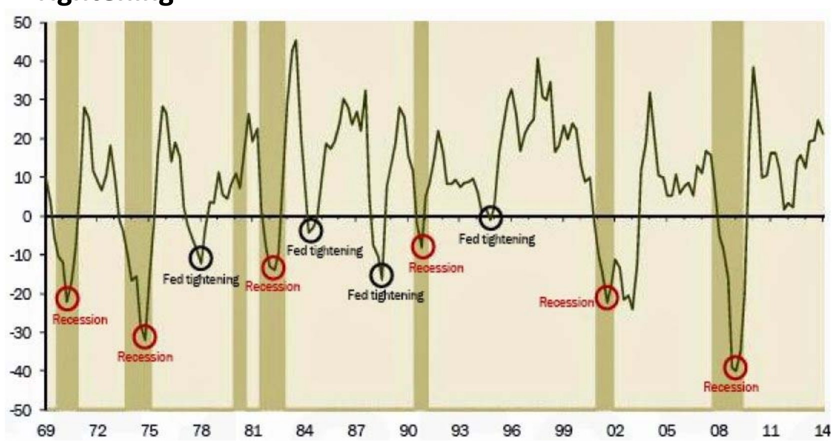
Consequently, we find ourselves on the optimistic side of the economic growth debate. Strong economies and investment markets tend to go hand-in-hand. Unless, in some occasions when the Fed increases its interest rate target. The primary reason this decision would be made is to dampen the risk of higher than desired inflation levels (greater than 2%). The secondary reason to do this would be policy normalization given the unusual current target of 0%.

In a moderately growing economy (like the one we have now), a zero-interest-rate-policy (ZIRP) is abnormal. ZIRP has historically been viewed as the end of the line in terms of accommodative policy since low interest rates 1) make it easier to borrow and 2) incentivize risk-taking from an investor's perspective.

The Fed argues that ZIRP is necessary since they see a lot of slack in the economy. We believe the Fed will adjust its stance on inflation – or at least its stance on ZIRP – by sometime this winter. This equates to policy tightening (i.e. raising the rate target).

As the chart below indicates, the risk associated with policy tightening relates to potentially weak market returns.

Stock Market's 12-Month Price Change:
Weak Returns Associated with Recessions and Federal Reserve Tightening



Note: Shaded regions represent recessions.
Source: Gluskin Sheff.

Investors should maintain their long-term strategic asset allocations

As a result, we believe this winter will be interesting since the potential for tightening is higher. On one hand, tightening is associated with market pullbacks since removing the economic punchbowl is associated with intentionally slowing economic growth. On the other hand, some tightening could be viewed positively by investors who believe ZIRP is currently detrimental to savers since estimated inflation (low as it is) is actually higher than many risk free interest rates (i.e. US Treasury Bills and Notes).

As a result, this leaves us neutral on the stock market. A change in stance by the Fed potentially leads to a market pullback of some significance; yet it possibly presents a buying opportunity as policy normalization may be greeted warmly. Given this view, we believe investors should maintain their long-term strategic asset allocations.

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