



Preparing for Surprises and the Unexpected

The HITCH Update — (*The HAHN Intellectual Tap-dancing & Chicken Heroics Update*)

Quarterly Strategy Comments & Updates
- September 2010

Key Considerations & Decision Points:

Major Current Investment Themes & Key Issues

1. Again, a new consensus erupts suddenly: Most now see the future as dark and grim. Economic growth expectations are lowered.
2. A major interjection could exist due to Bernanke Bravura. The Fed has clearly stated that it will do what it is necessary. In effect, for a time at least, it is a “put” for equities. But how much bad news will it take for action?
3. Disastrous economic scenarios are now being widely predicted. Will these act to prompt decisive government and monetary responses? Hands are tied.
4. The Fed has a few “tricks in the bag,” though can only delay ultimate outcomes.
5. Bond market is still priced for doom; stock market not. Which is right? We think the answer is in the middle ... a muddle thru for a period of time.
6. Just what scenarios are not being expected at present that could surprise the doomsters ... even if only temporarily. We list a few.
7. Crucially, President Obama has announced a partial dismantling of the Industrial Military Complex. A pull-out from Iraq is in process. Though disastrous geopolitically for the long-term, it could contribute to a decline of the budget deficit.
8. Generally, the market outlook now rides on 1H 2011 developments. Will second “stop” prove to be a new recession ... or the slow, flat “New Normal”?
9. Competition between the surplus and deficit nations for exports remains major focus point. This is a major problem for the USD over the intermediate term.
10. High hopes for the emerging world remains the central plank of most global economic/financial views. It may be the next bubble along with top tier MNCs. We recommit to India and Brazil, longer-term.
11. Dangerously, most asset classes and types now highly correlated with few alternatives for diversification. Searching globally, we have moved into a few asset-types that offer some counterbalance.
12. Austerity policies are being rewarded in Germany, Japan and even Great Britain. Would it be a viable if all nations were to do so? History does show that major economic slowdowns can be avoided if productivity goes up while debts recede.
13. The major millstone hanging on the neck of economic recovery remains: Low credit and money growth, still comatose real estate values. For the U.S., they remain defining indicators.
14. The post-GFC world is different than the average post-WWII cycle. It remains a “deleveraging” era with ongoing imbalances until proven otherwise. Our base economic case is a “slow, slow L” (SSL).

15. Our economic prognosis remains intact — an upward-sloping “L” for the next 2 to 3 years which would be bullish (all other scenarios considered).
16. What “weakest link” country bond market will contestants eliminate next? The UK, or Japan ... the U.S or France? The order matters.
17. China in the pincer ... between rising labor costs and currencies. The consensus has been disappointed. We are on the look-out for renewed stimulus ... evidence of continued decoupling from the ROW.
18. Gold ... a consensus outlook based upon 1930s myth. Does the recent rally offer an exit point? Given the geopolitical and other wild-card risks, we hold on.
19. Companies Without a Country: The case for “big cap”, high-yielding equities: Even more attractive than corporate bonds and cheapest in decades.
20. World now in an unstable “post-globalism” period with conflicting and competing policy prescriptions. Volatility risk therefore above average. “Companies with no Country” a well suited strategy.
21. While the shorter-term outlook could indeed stabilize, macro-global instabilities nevertheless continue to mount virtually guaranteeing further crisis in the years ahead.
22. For retail investors, a sense of hopelessness and fatigue is setting in. However, the current flight from equities is likely to be untimely. The death of the “equity cult” is being widely endorsed.
23. Canada: Is its popularity deserved? Not entirely. But we continue to like Canadian bonds one of the few, but small, quality bond credits in the world.
24. Preparations appropriate for possible USD volatility if Bernanke is forced to pursue unprecedented measures.
25. Brazil and India ... cyclical inflection point anticipated. Finally, we re-enter.
26. As per usual, we recalibrate odds of various scenarios. (Pgs. 25-27)
27. Geo-political risks are higher than average. China/US spats could turn ugly, seriously disrupting Asian financial markets. Also, China’s efforts to diversify reserves anger Japan and S. Korea.

Long-term Investment Themes

28. Viewing global investment policy through bipolar lenses: The Occidental Schlerotics vs. the Financializing Growth countries. But, latter group, for now, we think still dealing with recent downsides of “bubbles” & inflation.
29. Deflationary/deleveraging factors remain in the forefront. Keynesianism now at end of rope.
30. Slow-growth in Industrial West favours large MNCs with global range.
31. A focus on real yields & income remains key theme.
32. We are moving further to “thematic” and “special situation” emphasis, delinking from stagflationary outlook and deteriorating government finances.

Significant Event (SE) Watch

(Significant Events currently monitored, that are anticipated to support or trigger future strategy shifts.)

Triggered: The second economic “stop” (For more SE/s see Section III, pages 22-24)

Pending and New (Questions):

1. Austerity initiatives in the U.S. or more stimulus?
2. European Monetary Union developments?
3. Monetary channel watch: Deflation/Inflation indicators?
3. U.S.

bond demand dynamics? 4. Currency intervention on part of Japan, ECB, China. SNB? 6. Evidence of bottom of second economic dip. 7. Tea Party. 8. Geopolitical risks.

Investment Stance – Key Distinctions

1. To be determined.

Assessment: (Overall Financial Markets) Medium to above-average risk.

7-Year Return Outlook: From 5% to 7% average for HAHN balanced portfolios.

Other Strategy Resources: *Global Wealth Perspective* – July 2010

ETFfocus – August 2010 *Global Spin* – September 2010

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*** For these sections please see HITCH posted to the HAHN Adviser Portal

SECTION 1: Overview

For this quarter’s strategy discussion, we outline various issues in short form, as well as reproduce a portion of our interim strategy discussion document this past quarter. As our changes of a month ago were envisioned as likely being part of a phased shift, some of these earlier issues are still relevant (and have been updated).

Overall, the current environment remains without much precedent ... hardly conforming to a regular post-World War II investment cycle.

Numerous structural issues, macro imbalances, as well as decelerations in a number of secular trends complicate the picture.

Above all, 4 factors define the current times.

1. Deleveraging: Debt is being reduced ...at the very least, debt growth rates are being curtailed. This condition varies by country or sector. A “balance sheet” adjustment is affecting overall demand and economic growth. These types of adjustment typically unfold over a period of years, rather than quarters.

2. Demographics: A rapidly aging population, along with lower birthrates as finally tipped the vessel as far as funded pensions and old age support costs relative to underlying personal income is concerned.

3. Wealth Skew: Wealth stratification has become extreme in the Anglo Saxon nations, particularly the U.S. This is an impediment to economic growth.

4. Global savings imbalances (which have yet to self-correct, a process actively opposed by the surplus countries).

All the above, together, conspire to produce lower economic growth in the advanced nations, unique inflationary effects, and likely unprecedented reactions and trends in capital markets.

Quoting an insightful research report just issued by the Bank of International Settlements: “Financial crises tend to be followed by a protracted period of debt reduction in the non-financial private sector. [...] If history is any guide, we should expect to see a much more significant

reduction in private sector debt, particularly of households, than has so far taken place after the recent crisis.”¹ Providing some historical background, the report is quoted further:

“In 17 of the 20 systemic banking crises in our sample that were preceded by a surge in credit, there was a subsequent reduction in private sector indebtedness. On average, the ratio of credit to the private sector to GDP fell by 38 percentage points after these 17 crises, returning to a level similar to the pre-boom situation.

On average, private sector credit over GDP increased by 44 percentage points before the crisis, followed by a drop of almost the same magnitude (38 percentage points). Although there is significant variation across these means, it is striking that even the smallest amount of debt reduction (in Chile, where debt/GDP fell by 10 percentage points between end-1982 and the third quarter of 1983) was larger than what we have seen to date after the most recent crisis.

Debt ratios can be cut in various ways: paying off or defaulting on debt outstanding (we cannot distinguish between the two on the basis of the available data), economic growth, or inflation. We find that all three effects played roughly similar roles. Of the average decline in credit to GDP of 40 percentage points (excluding Chile 1982 and Philippines 1997, where quarterly real GDP data is not available), inflation and lower credit contributed 14 percentage points each, and real economic growth a further 11 percentage points.

Finally, there is also a theoretical argument that debt reduction need not reduce growth on a sustained basis. Biggs et al (2009) suggest that changes in the *flow* of credit (ie the second derivative of credit) are more relevant for output growth than changes in the *stock* (ie the first derivative).”

SECTION II: Issues to Ponder

Top of the List: Bernanke Bravura!!!

The U.S. Fed, at the recent Jackson Hole proceedings, has said in no uncertain terms that they would do what is needed. The unprecedented is to be expected. This is a significant statement that best not be unheeded. Why?

It basically amounts to a “put” on equities. Any sign of economic deterioration will be met with a strong response on the part of the Fed.

Michael Pento of Forbes Magazine frames the issue succinctly:

“If you think I'm using hyperbole, read these three quotes from Banana Ben's speech last week from Jackson Hole Wyoming. First there's this gem; "The FOMC *will strongly resist* deviations from price stability in the downward direction [deflation]," Then Ben explained how committed he is to running our currency into the dirt when he said the U.S. central bank "*will do all that it can*" to ensure a continuation of the economic recovery and that more securities purchases may be warranted if growth slows. He then cued investors into just how strongly he desires a return of rampant money supply growth and asset inflation when he said; "The Committee is prepared to provide additional monetary accommodation through *unconventional measures* if it proves necessary, especially if the outlook were to deteriorate significantly.

¹ Debt reduction after crises. Garry Tang and Christian Upper, Bank of International Settlements

By using the phrases "will do all that it can" and "unconventional measures," Bernanke doesn't just mean purchasing more mortgage backed securities or longer-dated Treasury debt because he has already done those things in spades. He means that the Fed will not only monetize assets held by banks but will purchase assets directly from consumers and bypass the banking system entirely."

Just what action could the Fed initiate? There remain quite a few "tricks in the bag. For instance:

1. Buy equities, real estate or other assets (as did Japan's central bank in the 1990s). This would force more money into deposits yielding zero.
2. Introduce negative interest rates on bank reserves, thus forcing them to lend and consumers to spend.
3. Sink the dollar significantly through the above policies

While none of these new interventions will change the long-term outcome for economies, over the short-term, significant tradable equity market rallies can occur. Japan, throughout its near two decade "flat-lining" trend for its economy, has experienced periodic equity market rallies ... some of 50% and more, lasting a year or more ... before again succumbing to declines.

Undoubtedly, an "unprecedented" action on the part of the Fed could easily drive up the equity market 5% or more in one day. At present, markets are quite vulnerable to such a scenario.

Dismantling the Military-Industrial State: Implications for the Budget Deficit

On August 31st, President Obama announced a determined schedule to exit its military operation in Iraq. The U.S. has decided to emphasize jobs ... not keeping peace in the Middle East. While this ultimately will prove disastrous for America's position in the Middle East, it does yield a peace dividend at least for a time. The US has been spending as much as \$200 billion per annum in Iraq. Cessation of operations in Iraq could reduce the U.S. budget deficit by as much as a sixth. This would be welcome news to bond markets and possibly make available funds to other stimulus items..

Additional Major Macro Issues to Dodge

Global Savings Adjustments: "The major global adjustments haven't yet taken place and until they do, we won't have seen the full consequences of the global crisis."
(Source: Michael Pettis, July 20th, 2010-08-30)

Europe: As long as Germany remains at the centre of Europe, the EU remains a source of world deflation. That said, such policies virtually guarantee the break-up of the European monetary union. This may be positive for the core euro area.

Financial Reform: Basel III, FASB/IASB concessions to vested interests?

Real estate crisis in the U.S. continuing to erode banking sector.

Government debt still rising rapidly in the U.S. (and other countries). The U.S. is still the source of near 30% of all securities outstanding in the world. (Do U.S. treasuries really qualify as a safe asset?)

Corporations holding up on spending ... instead, accumulating cash.

Basic food prices continue to rise ... impacting the CPI and standard of living in less-advanced nations.

Oil Prices Remain Above \$70

Sovereign Wealth Funds Continue to Expand

Environment of Post-globalism

Financial Crises Have Not Been Repealed: More should be expected over the intermediate- to longer-term.

Germany Becoming Strong Player Geopolitically

A Pivotal Questions: Just How Severe the Second Economic Stop?

We have consistently argued that a second stop was due ... what we called the Stop/Go/Stop scenario. It is now here and it is likely that growth will be negative for the U.S. in the 3rd quarter of this year (that's the quarter we are in now.) Admittedly, the second dip took a little longer to arrive than we had anticipated. Of course, we had not fully imagined that so much government intervention could be possible over the intervening period. Whatever the case, impetus for the "Second Stop" is limited, we think. We never did define whether our second stop would comprise negative growth of two quarters or more (defining it as a second economic recession) or simply amount to a dramatic slowing of growth.

Whatever the case, a number of factors suggest that it will not be another cathartic bust with supply and demand shocks reverberating around the world. Many excesses have already been wrung out of the economy. The dead wood and underbrush has already been burnt in the previous fire. This is a ray of light.

Despite the Gloom, There is No Precipitous Drop-Off in Economic Activity.

In the meantime, key indicators on the pace of economic activity and trade continue to hold up. There is as of yet no precipitous fall off. For example, according to Railfax, shipments remain ahead of last year and show no sign of slowing down. Gasoline purchases remain higher year-over-year, signifying that the economy is indeed not falling off of a cliff. Also, trucking volumes remain steady ... though not growing strongly at this time.

Negative Sentiment Again Worst Since March 2009: Safe Time to Buy More Equity? Key Now to Look For Unexpected Scenarios.

According to most investors, the future looks grim. Not only are perhaps as much as a third of the American population feeling chastened and sobered by receding real estate values and joblessness, even millionaires have again become sombre. According to the Spectrum Millionaire Investor Confidence Index, wealthy investors are as worried now as they were several months after the final equity market lows of 2009.

Here a quote from Mark Hulbert (August 27, 2010-08-27) which documents the current extreme sentiment:

"Consider the average recommended domestic equity exposure among a subset of short-term stock market timers tracked by the Hulbert Financial Digest (as measured by the Hulbert Stock Newsletter Sentiment Index, or HSNSI). This average currently stands at minus 6.6%, which means that the average short-term stock market timer is actually recommending that his clients allocate 7% of their equity portfolios to shorting stocks.

In early August, in contrast, when advisers were insufficiently worried, the HSNSI stood at 35%. A week after my early-August column, furthermore, the HSNSI got as high as 47.5%.

This means that the average recommended equity exposure has dropped more than 54 percentage points in a little more than two weeks' time.

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Even Wall Street securities analysts are subdued:

"For the first time since at least 1997, fewer than 29 percent of ratings for stocks covered by brokerages worldwide are "buys," according to 159,919 recommendations compiled by Bloomberg. Analysts are turning more pessimistic even as they push up estimates for profit growth among Standard & Poor's 500 Index companies to 36 percent, the highest since 1988.

More than 54 percent of ratings for companies in the U.S., U.K., Japan and Brazil are "holds," the highest level since Bloomberg began tracking the data in 1997. While the proportion of "sell" ratings in the U.S. has fallen to 5.1 percent, half the level of 2003, the total combined with holds" reached a record 71 percent last month, the data show."
(Bloomberg, August 30, 2010)

According to the recent AAll poll, only 20.7% of members polled were "bullish." This is the same level as occurred March 5, 2009, only a few days before the final equity market low in the U.S.

It is instructive to not forget that markets do climb a "wall of worry." If there were no worries, markets would already be at a much higher level.

But, Corporate insiders are the now the biggest buyers since March of 2009:

"Corporate insiders have cut back on the pace of their selling of shares of their companies' stock — and increased the pace of their buying. They, therefore, are betting the market will soon rally. In fact, insiders' behavior at the end of August was more bullish than at any time since late March and early April of 2009, when the bull market was just three weeks old." (August 31, 2010, MarketWatch)

Canada: Strange Brew? Time to Get Cautious?

The Canadian equity markets have significantly outperformed U.S. stock markets this year. (TSX60 up 2.5%, S&P500 down 3.0%). This relative outperformance certainly aligns with the general sentiment: Global investors are keen on Canada.

However, there are some warnings signs not to ignore.

1. Canadian households are now highly indebted. Real estate values may be over-extended and modestly overleveraged.
2. The CAD dollar has been surprisingly weak given the purported enthusiasm on the part of global investors.

3. Canada has its California fiscal disaster, too. Ontario's \$19 billion deficit is on par with California.
4. Canada's trade deficit is hitting new highs, despite relatively strong commodity and oil prices.

One scenario in which an underweight in Canadian equity markets would prove to be ill advised, is if drastic measures are taken by the Bernanke Fed. If so, this is likely to cause the CAD to soar and equity markets to also appreciate.

Are Safe Assets in Short Supply? Will This Remain Over-riding Investment Theme

Bond prices had been soaring ... the countries with the best balance sheets are suffering strong currencies. Anything that appears sustainable or durable is being bid up. How long will the "Safe Asset" theme prevail?

Over the past century, there have been only two countries that have recorded 10-year interest rates at less than 1.0% — Japan and Switzerland. By comparison, the U.S. had much higher rates during the Great Depression.

The outlook for bonds hinges directly on the question of how deep and wide any economic downturn is likely to unfold.

But are bonds just being bought because they are safe? There is another potential reason: Jonathan Allum comments:

"For the time being, risk-assets are in retreat and "safe assets" are in apparent in short supply the world over. Is the rushed search for safety overdone? The Japanese experience – over both the long and the short term – suggests something different and rather darker. Despite all the alarmist rhetoric, the bond vigilantes have been perfectly happy with the JGB market, presumably because Japan offered something much rarer than mere fiscal rectitude, namely deflation. If those charged with stewardship of a major economy really see their main task as keeping the bond markets onside, they should be wary. The price of this favour may not lie in slashing the deficit, which may be difficult to achieve, albeit a laudable long-term goal, but in fostering a period of substandard growth and persistent deflation.

That is not a desirable goal in either the short or long term. The good news is that it may, despite the Japanese example, be difficult for other economies to achieve. The bad news for bond investors is that their markets are already trading at levels that suggest that 1990s Japan is, as they now say, the "new normal". And this may not even be true of contemporary Japan.

One of the unfortunate aspects for countries that are considered an issuer of "safe assets," is that weak swimmers can together still pull down the strong swimmer. By virtue of funds rushing into Yen-or Swiss franc -denominated assets (indeed even Canadian) the currency can be driven up. This is a side-affect that it is not wanted by these countries. It can render these nations less competitive on trade, at a time that surplus nations are vigorously defending their position. As a result, a rush into safe assets can eventually undermine the value of the safe asset longer-term.

Global Fund Flows Dynamics (Michael Pettis): Some Possible Perverse Effects to Anticipate

Michael Pettis makes a provocative argument for a global capital tsunami headed for the U.S. He is a very thoughtful analyst (professor at a Chinese university). Basically, his argument is that, by process of elimination, the U.S. will continue to attract huge capital inflows over the next several years. If he is correct, this would certainly catch the pessimistic consensus entirely flat-footed at present.

<http://mpettis.com/2010/07/the-capital-tsunami-is-a-bigger-threat-than-the-nuclear-option/>

Crisis Have Not Been Repealed: Another One to Be Expected ... But Not Yet?

We see little that suggests that the care-keepers of the world's financial markets — whether regulators, international intergovernmental organizations like the Bank of International Settlements (BIS) or self-regulatory or private organizations such as IASB or FASB — have the upper hand. Special interests, vested stakes, the “big bonus” and the employee share option remain in the driver's seat.

The recent conclusions to financial reform in the U.S. were disappointing ... a hollowed shell, void of much punch and effect. Even some of the WMDs of the derivative world escaped the wrath of regulators. And now, the BIS, at long last intent upon concluding Basel III (Basel II never happened after almost 12 years of wrangling between special interests and the policy-makers) is also disembowelling some of its proposed policies designed to ensure financial stability for planet earth.

Why? Vested interests in the financial institution sector are playing their favourite card. During the depths of the GFC, the plaintive cry was, “You can't have an economic recovery if you don't save us first!” Now, it's the same tune but with a variant on the refrain — “Global economic growth will be retarded if we are not allowed to lever up.” Economists were found that could deliver a study to prove this argument. Of course, other economists were found that could disprove the previous group of economists. We are at square one, left to choose our favourite economist's validation.

There is no reason to expect that there will not be another financial crisis ... perhaps even within the next three years. Another financial crisis is already in the making. In that sense, the outlook for the world's financial systems and the distribution of wealth has not improved.

Austerity: A Winning Policy in World Short of Safe Assets?

Allow us to develop a scenario ... one that we are assigning a larger probability than just 3 months ago. Admittedly, there are a number of other scenarios that have sizeable probabilities that we cannot ignore.

There appear to be some proofs the notion that elbow grease and sensible stewardship is not bad for either economies or financial markets. Consider Germany today, or the nations that rebounded from the Asian Crisis of the late 1990s. Higher productivity and lower prices (even deflation) —and importantly, the clear signal from governments that largesse and inflationary policies will not be used to bail-out sluggards or parasites on the public trough — lead to stronger economies and external accounts balances.

Are these indeed sustainable policies in a world where countries are competing to export away their lack of domestic demand?

Some analyst have called it an “Epidemic of Thrift” ... the great evil seen to be not enough demand ... households that are not buying.

Good News: Deleveraging is Progressing

Deleveraging is occurring in the private sector, not the public sector. Actually, to be more precise, deleveraging is occurring only in the “household” sector.

The amount consumers owed on their [credit cards](#) in this year's second quarter dropped to the lowest level in more than eight years as cardholders continued to pay off balances in the uncertain economy. *By EILEEN AJ CONNELLY, AP Personal Finance Writer*
Eileen A Connelly, Personal Finance Writer – Wed Aug 25, 3:32 am ET

Credit card debt in the U.S. is now at the lowest level since 2002. FICO scores have improved and are now higher than 2008 levels. These appear to be positive trends.

Do Emerging Markets Offer the Great Escape?

U.S. Political Cycle: Impact on Markets?

The political election cycles in the U.S. revolve on a shorter axis ... namely, every 2 years. The mid-term elections take place in early November. Here, a possible point of emergency is nearing if the incumbent party is to stay in office. There are only a few options ... and none are guaranteed to work:

- #1. Somehow, to encourage a national spirit of hard work, industry and savings (Germany's route at the present) much as what occurred in many Asian countries during the Asian crisis of the late 1990s.
- #2. Go further down the terminal trail of deficit spending, bail-outs, perhaps mortgage forgiveness ... etc. It must stop consumers from deleveraging and again spend.
- #3. Do Nothing. This option is not politically viable as higher economic growth is needed over the longer-term to observe
- #4/ As a stalling tactic, temporarily find a culprit or smoking gun to blame. This would be the approach of the populist or a demagogue. Perhaps to be considered is a redistribution of wealth. (The U.S. is not yet likely to consider this option.)

Continuing Stratification of the Economy Middle class being destroyed

This is a sad issue that should hardly be presented as a ray of sun. However, to this point we have been only talking about station stops ... temporary cessations, really ... of longer-running downward trends. The U.S. economy (likely also the UK's, not so much Canada's) has recently experienced an acceleration on its road to terminal polarity in its income and wealth distributions. A large segment of the middle class and near-retirement “baby boomers” have been financially annihilated over the past few years. Large numbers of the foreclosed and jobless have become virtual economic refugees (or Third World America, a name Arianna Huffington has coined in a new book of the same name) even as wealth has accrued to an ever-small minority. Remarkably, while home prices have fallen, the prices of some collectibles and rare art have continued to rise. Even as large numbers are economically terrorized, another demographic is sportingly “stink-bidding” on foreclosed properties and holding up consumption on luxury goods. Our point is simply that this acceleration in the wealth shift will likely now stabilize for a time — though bringing the Gini scores ever closer to the infamous levels of some Latin American countries. The economy has already geared down to this reality, with the next

abrupt shift likely awaiting the next financial crisis. Admittedly, this is not a ray of sunshine, only an indication that the rain may stop for a short time.

A Pending Question to Revisit : Gold ... Time to Sell? We Continue Holding

Something that the “gold bugs” may not fully appreciate, is that bail-out packages, even as large as \$1 trillion as in the case of Greece et al, are not inflationary if these interventions are sterilized and involve spending cuts. For a period of time, indeed, low quality bonds are inflated in price as they are swapped for government bonds on the central bank’s balance sheet. (We are presently still carrying an overweight position in gold bullion, and have done so for quite some time. That said, we are not gold bugs nor in the “gold is God’s money” camp.”

Another myth about gold is that it is “depression-proof” asset and that gold stocks are fated to perform best in a long-term bear market. This premise is primarily based upon the experience of the 1930s. Gold stocks significantly outperformed during the early 1930s ... in fact, delivered positive returns. But, this was not due to free-market preferences for gold. Rather, this was due to the gold price being fixed by the U.S. government at a level greatly above the cost of its mining. The U.S. treasury bought all gold (unlimited amounts) at that price. This served to boost the profits of the gold mining companies.

Could the “gold bugs” be wrong? Several factors could mitigate against the consensus view. (We mention a number of these in a recent Global Spin of December 2009.)

1. History argues that it is possible that overindebted countries can end up in disinflation or deflation ... with falling interest rates. This is the classical debt trap. In fact, in one sense, this outcome is ever the more likely as governments try to spend their way out of a “balance sheet” recession as is occurring now. Ultimately, interest payments as a share of GDP rise to untenable levels. (The U.S. Congressional Budget Office currently projects federal government interest payments to rise to from the current 8% of revenues to 17% of revenues by 2019.)
2. It is a reasonable deduction that a new real estate bubble will not be initiated anytime soon. And, without the availability of such a substantial source of collateralization for some time, it is a further logical deduction that debt growth will remain flat to negative. This is a deflationary process that therefore can be expected to continue.
3. Unique effects of advanced globalization upon capital flows and the manifestations of inflationary policies.
4. World-wide conditions are radically different than during the previous period of strong advances in the USD gold price. Demographics, pension crisis, an income crisis, all argue that the focus of investors and institutions could be radically different.
5. Bond markets of the Western world have dealt with an inflationary phase before (certainly so within living memory). Therefore, bond markets are likely to be highly vigilant against price inflation.
6. The end of the rope for Keynesianism as mentioned elsewhere in this document.

For now, we continue to hold our 5% over-weight in portfolio opportunity weightings.

Excerpt From Mid-Quarter Discussion Document

Liquidity Watch ... One Channel is Wide Open Which Favours Equities

Capital markets are likely to again become “decoupled” from economic growth in the Western world. How so? For example, of the various scenarios we have been probability-weighting, one has given us the most anxiety (namely, in the sense that we may miss a major up-trend). This was the “velocity inflation” scenario in which a “flight” into quality equities would occur. To be sure, it would be an unusual development in that there is not much precedent. However, the times are indeed unprecedented and the worries about “safe assets” at near histrionic levels.

Allow us to explain our reasoning. The effects of any monetary expansion, depends on the channel of delivery. For example, if a money expansion is expressed through increased mortgage loan growth, then the inflationary effect will be upon an asset, namely real estate. In the same way, we can deduce which monetary channel is most likely to be the conduit of monetary expansion. It is securities.

Well recognized is that liquidity has been pumped into the banking system and that direct government deficit spending has added extra GDP growth. We have been on the alert, trying to identify just where inflation might express itself. At this point, the usual channels are blocked. Banks are not lending; consumers are not borrowing. This suggests that inflation will not first vent into “consumer price inflation. To date, monetary inflation has impacted risk spreads, (causing risk to be under-priced) as well as pushing money up the yield curve.

Liquidity (or reserves) are again building up in some key sectors ... crucially, all of these being asset-market intensive (non-bank) sectors.

- U.S. Corporations now have accumulated an astonishing \$1.8 trillion in cash on their balance sheets. This is unprecedented. Cash generation remains high as capital spending has collapsed. Given low capacity utilization rates, new Greenfield spending is unlikely. In a slow growth world (with the possible exception of MNCs
- Corporate Share Buybacks: “U.S. companies have authorized \$251.8 billion of share repurchases so far this year, the Westport, Connecticut-based research and money management firm founded by [Laszlo Birinyi](#) said in a note sent to clients today. That’s \$2.28 billion, or 0.9 percent, less than at the end of August 2008. Corporations spent \$88 billion more on buybacks in the second quarter than during the first three months of 2010. (Source: Biryni Associates)
- SWFs: With oil at levels still above \$70, funds continue to flow to the energy producers, their investment and currency reserves piling up. (Abu Dhabi recently was contemplating buying BP.)
- International reserve assets were up \$1.617 trillion year-over-year ... or 23.7%, to a record \$8.434 trillion. This provides an indication of financial liquidity. An increase of nearly one-quarter can only be considered gargantuan, underlining the need for huge capital recirculation into “safe” assets..
- The Hedge fund sector to date (privateering money which can be mobilized quickly) has high cash levels. As a financial sector they account for over 20% of U.S. equity trading volume in the U.S. Most are in a capital preservation mode at present. This industry manages \$1.67 trillion.
- The Private Equity industry in the U.S. is flush with cash ... with no where to put it to earn their fees. Uninvested cash levels are estimated at \$500 billion in the U.S.

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- Chinese banks this year have issued more than \$60 billion in capital. This will further underpin their fast loan growth, and indirectly, the recycling of funds back into other global assets (mostly, sovereign bonds.).
- The savings rate of the world's advanced countries has risen to a level equivalent to 7% of GDP ... or \$3 trillion.
- There is a lack — a shortage — of “Safe Assets” in the world. Currently, top-quality MNCs and U.S. treasury bonds are considered safe.
- Equity markets are reasonably priced ... neither cheap nor expensive. However, if a “velocity” inflation unfolds, valuation will not be a hindrance in the search for “safe assets.”

Says Bill Miller in recent FT article:

“The point here is simple: US large capitalisation stocks represent a once-in-a-lifetime opportunity in my opinion to buy the best quality companies in the world at bargain prices. The last time they were this cheap relative to bonds was 1951. I was one year old then, but did not have sufficient sentience to invest. I do now, and if you are reading this, so do you.”

Companies Without a Country: Why MNCs Can Decouple From Slow Growth Environment

Situation Different Than Japan

While Japan's balance sheet recession affected the equity market significantly (down over 80% from its 1989 top at one point) the situation is different in the U.S. in at least one important respect: Deleveraging is not taking place in the corporate sector. While Japan's over-indebtedness was concentrated in the corporate sector, it is the household sector that is deleveraging in the U.S. As such, the downside for large-cap equities is not as severe as in Japan.

Why Dividends are the Big Hope

Quote from James Montier

Taking U.S. equity market data since 1871, Montier has worked out that when you look at it on a one-year time horizon nearly 80 percent of the return has been driven by changes in valuation. However, on a five-year view, a much more meaningful period, 80 percent of returns are actually generated by dividend yields and by dividend growth.

Taken over the very long term the importance of dividends and dividend growth has been even more important, driving about 90 percent of total returns.

Part of the move away from dividends in the past 20 years can be explained by a quick look at many top executives' contracts: stock options mean they get paid not for driving total returns over longer periods but for driving up their companies' stock over two- or three-year horizons. That led, at least until the crisis, to a huge substitution of stock repurchases for dividends. Reuters Aug 26, 2010 07:25 EDT

OTHER FACTORS

A Take-over Mania Ahead? Times of low GDP growth (as we think will be likely for some years) therefore implies lower corporate revenue growth.

Corporate behaviour is not difficult to model. It remains that corporate executives are highly incentivized to deliver earnings growth ... particularly through the impact of stock options. They will try to promote higher share prices — perhaps even inventively — certainly so once uncertainties have been resolved.

Given low GDP growth, efficiency gains and financial engineering will be the prime means to boost earnings. In such an environment, it may be cheaper (and more instantaneous) to buy growth. As such, we should expect a revived mergers and acquisition environment. Furthermore, for quality companies, interest rates should continue to fall, gradually lowering their long-term cost of capital. This contributes a large boost to earnings.

That said, it is very likely that financial markets can become detached (this would not be new) from underlying economic realities. Capital markets are likely to again become “decoupled” from economic growth in the Western world. How so?

Investor Behaviour Likely to Be More Reactive

Median (absolute) investment returns have been poor this past decade. Many pension systems/funds are underfunded; the average “baby boomer” not yet having accumulated sufficient assets for retirement. Money managers are desperate to deliver positive returns following several meager years. Rallies can simply not be missed.

Should a “velocity inflation” get underway, the upside can unfold very quickly.

Are We Getting Too Bullish? What About the End of the World?

No doubt, the long-term structural outlook remains as discouraging as ever. To date, there have been no sustainable reparations to financial systems ... government borrowings remains unprecedentedly high ... the Euro is sure to fraction further in the years ahead ... etc. Long-term factors such as demographics, deleveraging, widening wealth skews, still-wide global capita flow imbalances ... etc. all will remain with us for years.

These are long-term factors that can certainly be temporarily obviated by shorter- to intermediate-term trends.

Nonetheless, these long-term concerns are legitimate, and therefore put a premium upon “safe assets.” Largely, this is a status determined by popular perception. For example, while U.S. treasury bonds continue to remain attractive investments (foreigners purchase nearly \$1 trillion of U.S. fixed assets this past year) Spanish bond markets were trashed even though its debt-to-GDP ratio is lower than that of the U.S.. Assets are safe, until popular sentiment believes otherwise.

A convincing case can be made that the securities of large multinational corporations rank a higher “safety” status than many sovereign bonds.

Stock Market Delinking from the Economy?

The notable exceptions to the current morbid mood are corporate executives. And, why not?

That senior corporations — globally diversified MNCs — could be expected to decouple (at least partially) from the recent nemesis of post-GFC economic torpor, has been a long-running theme. (See the *Global Spin* issues of March, *TNC Securities: The Devil Sovereign Bond Take the Hindmost*, and June 2010, *Austerity in Every Pot*.) In fact, we expect some of these MNCs to ultimately achieve better credit ratings than some major OECD-member governments.

Times of low GDP growth (as we continue to think will be likely for some years) therefore implies low corporate revenue growth. Corporate behaviour in such an environment should not be difficult to model. It remains that corporate executives are highly incentivized to deliver earnings growth ... particularly by the stock option. They will try to promote higher share prices, perhaps even inventively, but certainly so once uncertainties have been resolved.

As such, given low GDP growth, efficiency gains and financial engineering will be the prime means to boost earnings. In such an environment, it may be cheaper (and more instantaneous) to buy growth. As such, we should expect a revival of mergers and acquisitions. Furthermore, for quality companies, interest rate expenses should continue to fall, gradually lowering their long-term cost of capital. This contributes a significant boost to earnings.

The relative stability of non-financial earnings may be signalling a new era for corporate profits. In fact, we take this as somewhat of a confirmation of our MNC strategy ... the “Company Without a Country” theme. There are several supporting planks to this developing theme:

- Industry concentration increasing (i.e. witness the actions of global iron ore companies recently, Anglo-Australian, Vale, Rio Tinto)
- More reactive cost controls (rapid labour shedding, for example)
- Stronger balance sheets, high free cash flow
- Low, low interest rates for creditworthy corporations.
- Reactive reallocation of resources and production facilities around the globe.
- Moreover, we prefer MNCs that are inclined to serve the staples side of the economy and have broad global diversification — no more than 40% of revenues — in any one country. Regional and/or country crisis can be best weathered by globally diversified MNCs.
- Focus on high “real yield” and dividend income. Remarkably, dividend yields of some quality MNC/TNCs is now higher than 10-year government bond rate.
- The TNC strategy ... the preference of globally-diversified, “big cap” quality, corporate vs. sovereign securities. Companies with no Country with a high dividend yield.
- Big Caps ... now offering very high dividend yields. If (as predict Bill Gross of PIMCo and others) that average equity returns over the next decade are likely to average 4% per annum, then 4% plus dividend yields are way of immunizing acceptable returns ... and, must be considered a bona fide bargain given that some earnings growth may be expected as well.

SECTION III

Significant Events & Indicators to Monitor

- Pressure on U.S. Fed to act. Likely congress will not be able to push through a new spending bill anytime soon.
- Monetary Watch: List of indicators that will indicate channel of inflationary expression:
 - Monetary velocity – presently still very low (positive for financial assets).
 - Credit growth – remains negative year-over-year
 - Excess reserves remain high ... not yet drawn down.
- Are governments now restrained in launching further stimulus spending should a deep second-dip transpire? A new round of government spending stimulus programs in response to a flagging U.S. recovery, how will bond markets react?
- Ongoing commercial real estate trends?
- “Second dip” indicators?
- Indicators of residential housing stabilization ... or long-grinding process.
- Household income upturn and spending watch.
- China/US trade relations (China exports surpluses)
- AUD/EUR carry trade spreads.
- Currency interventions ... Japan, European Central Bank, Swiss National Bank. Major surplus countries to now want to give up their position.
- Gold versus U.S. treasury bond trends and denominated in other currencies?
- More Independent policy actions undermining G20 –type multi-lateralism, triggering more “beggar they neighbor” policies (a la Vietnam recently) ... increasing stridency of such countries as Turkey.
- China Watch ... how long can chronic savings excess, rampant bubbles and distortions be continued?

SECTION IV

Long-term Investment Themes

(Please see separate internal and companion Themes Document for full detail on themes and portfolio implementation ideas.)

Eclecticism ... Continued: When to employ?

Where to find outperformance and needed non-correlation to build portfolios with below-average draw-downs in a slow-growth world? A standard commitment to three broad asset classes and the ideology of hugging “market weights” will ensure low investment returns.

- Chinese yuan, Chinese money market? (According to a recent “Big Mac” poll by the Economist, the Chinese yuan is undervalued against the U.S. dollar by 49%. Other more theoretical valuation methods agree that the yuan is indeed undervalued on the order of 20% to 40%.
- Asian Fixed Income: This has shown significant non-correlation ... i.e. rupee bonds.

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- Consider Russian, Poland, rupee bonds, Brazilian bonds
- Focus on high “real yield” and dividend income. Remarkably, dividend yields of some quality MNC/TNCs still higher than 10-year government bond rate.
- Oil & energy development and infrastructure spending. (Shortage of cheap oil a recurring, procyclical phenomenon.)
- Global Infrastructure spending
- Food (agricultural) (Agricultural commodities have performed poorly (relatively) to date this year.) Long-term demand factors suggest that this sector may even outperform industrial commodities. Among long term factors: Arable land per capita continues to decline; productivity declines due to over-farming; Irrigation limitations; continued growth of world population.
- Water development
- Health industry (Aging crisis)
- Conservation technology
- Niche High Tech. In a world of slow growth, efficiency gains will carry a high premium.
- Alternative energies
- Urbanization
- Selected Emerging & Frontier Market Countries. Reasons why? These countries possess intact financial systems, excess reserves, investment-based, high-savings economies. Low financialization levels, suggesting further development potential. Faster economic growth prospects. Faster relative growth of standard of life (PPP per-capita GNI).
- The TNC strategy ... the preference of globally-diversified, “big cap” quality, corporate vs. sovereign securities. Companies with no Country with a high dividend yield.
- Core eastern European countries (i.e. Slovakia, Czech Republic and Poland) have low debt versus GDP and higher yields. Russia is attractively priced presently, and has been non-correlated in the past.
- Big Caps ... now offering very higher dividend yields than 10-year treasury yields. Even were economic growth to average 1% for several years, this is sufficient to allow big-cap MNCs to generate higher returns than treasury bonds.
- Brazil ... other resource countries once inflation threat has subsided.
- Focusing upon “hard currency” or “safe haven” countries, especially for international bond weightings. (Sweden. Singapore, Switzerland ... etc. Also to consider, countries such as Saudi Arabia and Russia have debt levels below 20% of GDP.
- Emerging market currencies
- Timberland

Section V

Portfolio 7-Year Expected Returns

Most Recent Revised Forecast March 2010 (Remain in effect at the time of this publication.)

| Asset Class (CAD) | 7 Year Averages | | Gains Total | Gain Currency | Gain Security | Income Total | Dividends | Interest |
|------------------------|-----------------|---------|----------------|------------------|------------------|-----------------|-----------|----------|
| | Real | Nominal | | | | | | |
| Cash | 1.25% | 2.19% | 0.00% | 0.00% | 0.00% | 2.19% | | 2.19% |
| Cdn. Stocks | 3.22% | 4.18% | 2.08% | 0.00% | 2.08% | 2.10% | 2.10% | |
| US Stocks | 4.68% | 5.66% | 3.41% | 1.44% | 1.97% | 2.25% | 2.25% | |
| International Equities | 5.97% | 6.96% | 3.66% | 2.59% | 1.07% | 3.30% | 3.30% | |
| Emerging Equities | 7.35% | 8.35% | 4.60% | 2.59% | 2.01% | 3.75% | 3.75% | |
| Cdn Govt. Bonds | 2.94% | 3.90% | 0.00% | 0.00% | 0.00% | 3.90% | | 3.90% |
| US Govt. Bonds | 4.68% | 5.66% | 1.66% | 1.44% | 0.22% | 4.00% | | 4.00% |
| Int. Govt. Bonds | 5.57% | 6.55% | 2.75% | 2.59% | 0.16% | 3.80% | | 3.80% |
| Other Alternative | 8.10% | 9.11% | 6.61% | 1.44% | 5.17% | 2.50% | 1.00% | 1.50% |

Wilfred J. Hahn, September 2010