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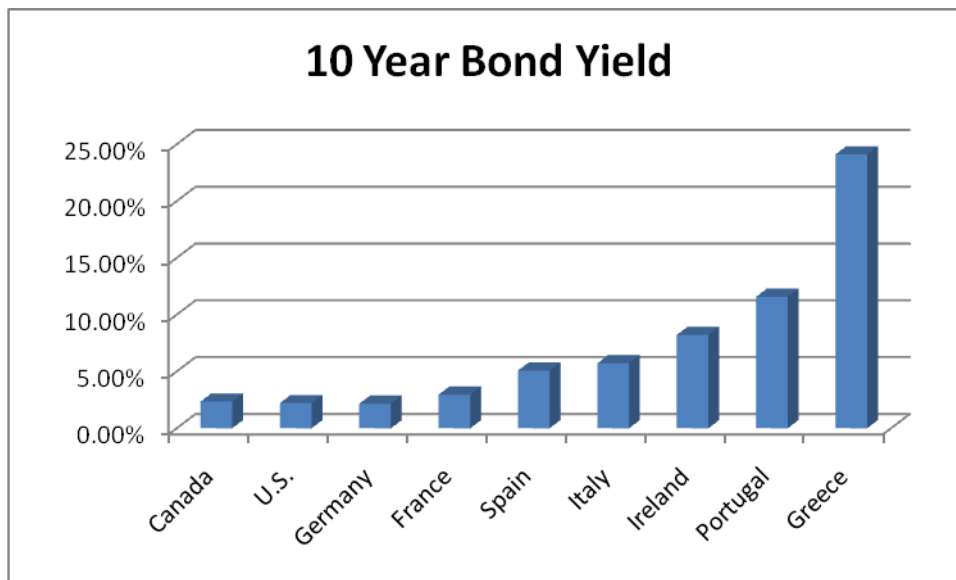
Quarterly Investment Review – September 2011

European Financial Crisis Pounds Stock Markets While Bond Yields Drop to Record Lows

Global stocks fell during the third quarter as the European Debt Crisis spread to the banking system and policy inaction continued. In the U.S., difficulties in raising the debt ceiling, loss of the AAA credit rating by one rating agency and more weak economic statistics contributed to the decline. The MSCI World Index declined 10% during the quarter and now has a negative annual return of 2%. The TSX had a poorer showing due to the high commodity weighting. On a sector basis, utilities and telecommunications lost little value while metals and energy were hard hit. Bond prices benefitted from investors' fears. Bonds earned 5% during the quarter and 7% for the year. Returns on cash were .3% and 1%, respectively.

Contagion Risk of European Financial Crisis Threatens Global Economy

What started out as a fire in a pot on a stove (Greek debt crisis-Greece represents 2% of the Euro Zone) quickly engulfed the kitchen (Portugal and Ireland). A fire extinguisher was used to try and put out the fire, even when it spread beyond the stove (delayed and inadequate policy action). The entire house ended up in flames (Italy and Spain) and finally the fire department was called in. The firefighters are at the scene (European leaders) with all the necessary equipment (ECB, EFSF, IMF) to contain the fire and eventually put it out but, instead of getting into action, they are standing around talking about the best way to tackle the flames. Now the neighbors' houses are on fire (European banks).



Source: Bloomberg as of October 12, 2011

The fire is taking place primarily in European sovereign debt and interbank markets. Virtually all countries borrow money and if their creditworthiness is sound, there is usually no problem accessing funds. In the case of Greece, if they were to borrow money for ten years, they would pay an interest rate of 24%. Greece cannot afford to pay this high interest rate because they already have so much debt to service and their economy is weakening by the day as they implement austerity programs. The rates for Ireland and Portugal are not as high but they are still extremely costly. Ten year bond yields for Italy and Spain are over 5%, more than double those of Germany. Traditional investors in "safe" sovereign debt have pulled back from the market and it is now up to the European Central Bank (ECB) to purchase bonds and keep the rates from going too high. At this time, the ECB has access to the \$607 billion European Financial Stability Facility (EFSF). This is not enough money to stabilize the sovereign debt markets. Italy alone has \$2 trillion of outstanding debt, the third largest in the world after the U.S. and Japan.

The second source of pressure is showing up in the interbank lending market. Because European banks own a lot of European sovereign debt and are facing losses on it, their capital positions have weakened. Banks are now reluctant to lend to each other. Investors that normally buy short term bank paper have also withdrawn from the market. Interbank lending rates have risen substantially but are not as high as in 2008/2009 during the credit crisis. The ECB is now

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providing one year funding for banks and other global central banks have provided liquidity to the interbank market to keep rates from rising too much.

What actions can be taken to contain the fire and eventually put it out?

- Expanding the EFSF to \$2 trillion would likely contain the fire. The current proposal would take it to \$1.1 trillion.
- The IMF estimates the amount needed to recapitalize European banks is \$138-\$276 billion. Similar to the U.S. TARP (Troubled Asset Relief Program), the EFSF could lend the banks funds to strengthen their capital ratios in exchange for securities. When the banks are stronger, they can repay the funds and redeem the securities.
- One proposal that would pour a lot of water on the fire is if Greece put assets into a trust that was managed by the ECB. The ECB would in turn provide funds to Greece for the assets and enable them to reduce their debt load to a manageable level. The ECB would sell the assets in an orderly manner in the hope of getting good prices for them.
- The Euro Zone has a common currency and a central bank but, does not have a common fiscal authority that can tax and issue bonds. If the Euro Zone is to remain intact, a move towards this structure will be needed. Think of Canada with the 10 provinces...PEI has a credit rating of A- while Alberta has an AAA rating. Overall, Canada has an AAA rating. (Dominion Bond Rating Service ratings) By issuing a "Euro bond", investors would be eager to purchase it because it would have the strength of Germany and France behind it and it would provide a means to fund weaker countries like Greece and Portugal. This would extinguish the fire once and for all.

As you can see, the situation in Europe is very serious and the scope of the problem has increased substantially during the past quarter. The good news is there are solutions. The bad news is policy makers are dragging their feet. The main risk in Europe is a lack of or insufficient policy action which allows the flames to keep spreading.

The IMF recently announced a downward revision to global growth for 2011 of 4% from 4.3% and 4% in 2012 from 4.5%. (World Economic Outlook: Slowing Growth, Rising Risks, September 2011) If the European crisis worsens, this would cause growth to be even lower. Other reasons for the reduction in the IMF's forecast were the substantial downward revision to U.S. growth in the first quarter, reduced confidence due to the European crisis and policy gridlock in the U.S., restrictive bank lending conditions as well as a faster pace of deleveraging by consumers than expected. Overall, the emerging countries are managing quite well and there is room for them to maneuver both fiscal and monetary policy should economic conditions deteriorate.

Capital Markets Expectations

We are maintaining our target for the TSX Composite of 14,800 however we do not expect to see this level until later in 2012. Earnings growth remains strong, buoyed by higher prices for many commodities compared to last year. Even if earnings were to decline 10%, stocks still look attractive. *The dividend yield on the TSX is now substantially higher than the 10 year Canada bond yield.* Interest rates are at very low levels and even if they were to increase a full percentage point, they would still be supportive of current valuations.

Bond yields are expected to move higher in 2012. Quantitative easing by the Federal Reserve to reduce longer term bonds yields will limit the rise along with continued low inflation.

The Bank of Canada is not expected to raise short term interest rates until the second half of 2012 or perhaps not until 2013 because the Federal Reserve has committed to hold short term rates down until the middle of 2013. Should the economic environment deteriorate, Carney could *cut* the bank rate.

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October 12, 2011