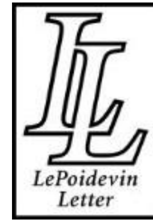
May 2008



Yield Curve Moves to Normal
Stocks Advance
Commodities Surge

Almost a year ago, in the June 2007 LePoidevin Letter, I warned that the yield-curve inversion (short-term interest rates higher than long-term rates) was leading to a tightening of lending standards and that the relatively small sub-prime mortgage crisis would spread. A recent Goldman Sachs' report reveals that the total losses-to-date from bank, hedge fund and government sponsored lending is a staggering $460 billion. I have heard a lot about the "bottom" recently; however, the Goldman Sachs' report estimates that the total losses will hit $1.2 trillion before this crisis is over.

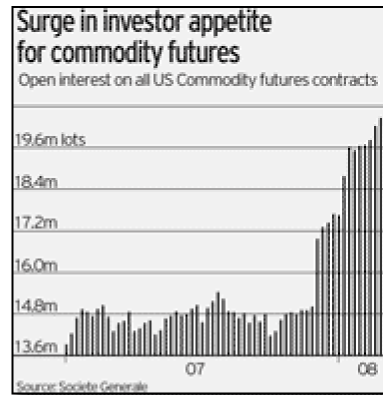
The U.S. Federal Reserve has responded to the credit crunch with the fastest interest rates drop in U.S. history from 5.25% at the end of 2007 to 2% by April 30th of this year. In addition to slashing interest rates, the U.S. Fed has pumped tens of billions of new money into the banking system in order to prevent bank failures. The U.S. government will soon begin mailing cheques to every U.S. taxpayer. Has it worked so far? Well… yes and no. On the one hand, U.S. foreclosures continue to surge to all time highs; and the U.S. Department of Labour has reported four consecutive months of job losses. Moreover, consumer confidence has fallen to its lowest level since 1980. On the other hand, first quarter GDP muddled along on the positive side at 0.6% annual growth rate – not much, but still positive.

The latest interest rate cut in the U.S. put the yield-curve firmly into positive territory with 10-year yielding 1.9% above the short-term Fed Funds yield. But let's not take out the champagne to celebrate the end of the downturn just yet; it will likely take more than a month of positive slope to get the banks to open up their purse strings. Remember the yield-curve remained inverted for 18 months before the lending crisis hit. The Goldman report estimated that further bank losses will continue to tighten credit conditions.

One might wonder why, despite a weak economy, energy and food prices have been surging, and why shares are rising. The most important factor affecting investment decisions is the risk-free interest rate alternative. As mentioned, in late 2007, investors were enjoying short-term U.S. deposits at 5.25% - now the rate is 2%. The latest U.S. inflation rate is 3.94%. As long as the real rate of return on risk-free assets is negative 2%, money will flow into shares,

even in a no-growth environment. Furthermore, money has been flowing into commodity futures funds, which in itself is driving inflation up even further, as seen in the graph below.

Chart 2: Open Interest on Commodity Futures



Source: The Daily Telegraph [1]

This is a U.S. election year. The U.S. Federal Reserve has a history of keeping interest rates low in an election year. As long as real interest rates remain negative, investors will seek out alternatives to government bonds. Unfortunately, inflationary pressures will continue to build while the all-items U.S. inflation at the retail level is 3.94%. The wholesale inflation is running over 7%, and import prices have increased over 15%! But, housing remains in decline and that seems to be the focus of the U.S. administration.

The U.S. has a history of bringing in the tough medicine in the first two years of a presidential cycle. So watch for interest rate increases starting late this year and well into 2009. For this reason, I have been recommending the 5-year Quebec Real Return bonds, where the interest rate is adjusted for higher inflation. I would avoid government fixed-rate bonds.

Artificially lower interest rates with rapid money supply growth created the stock market bubble which peaked in 2000. Then, a bubble formed in real estate, which is still in the process of collapsing. Just as the NASDAQ stock market fell 85% from peak to trough, most people have no idea just how far housing could fall. Now, a bubble is forming in commodities. However, until real interest rates return to a positive level, the commodity bull market could remain intact.

The stock markets continue to be extremely volatile and I would therefore use this weakness to add to companies which seem likely to weather a consumer-driven recession.

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[1] Jensen, Niels. "Food for Thought". John Mauldin's Outside the Box E-Letter. Volume 4 – Issue 29. 14 May, 2008.

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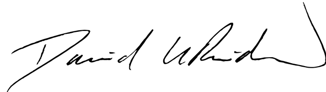
Watch for weakness in the U.S. stock markets as we draw closer to the U.S. November elections. Two things the market hates - uncertainty and high taxes, both of which might well spook the stock markets if Obama continues to do well in the polls going into the late summer/fall.

Sincerely,



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