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The impact of stimuli since the 2008 crisis

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Since the 2008 credit crisis, fiscal and monetary policies have been very accommodating. This was particularly the case in the U.S. where the Fed cut and maintained its discount rate at 0.25%. Unable to decrease it any further, it inflated its balance sheet by $2.3 trillion over three phases of quantitative easing. Meanwhile, the U.S. government ran budget deficits at the rate of about $1 billion per year.

By looking at history, one would have expected these measures to have provided a bigger boost to the U.S. and global economy.

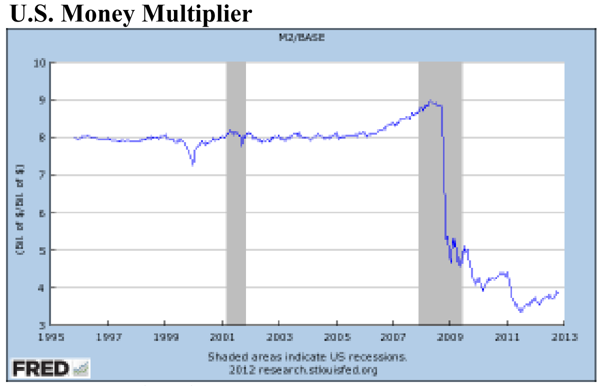
Why was the impact of the stimuli weaker than in past cycles?

Several factors have contributed to a mixed recovery. One of the more important causes is that following the credit crisis of 2008, individuals and companies started cutting expenses and deleveraging their own balance sheets. As a result, U.S. consumers, who had significantly increased their debt levels over three generations and witnessed a decline of about 35% of the value of their homes, chose to pay off debt rather than continue spending. Simultaneously, the banks, in response to stress caused by the credit crisis, tightened their lending criteria and worked to improve their balance sheets. Similarly the companies in the S&P 500 (excluding the financial) have increased their cash and short-term assets by more than 50%. They also reduced their labour costs, thereby contributing to the increase in the unemployment rate.

With respect to stimuli, when you add new money into the economy, it has a multiplier effect. For example: if the government spends on infrastructure, a contractor will pay wages to an equipment operator, who will buy flowers for his wife, the florist will benefit from the increased revenue to update his website, the webmaster will change cars, the car salesman will buy new clothes, etc.

The graph below illustrates the trend of the money multiplier for nearly 20 years. Historically every new dollar injected into the economy was spent about eight times over. However, since 2008, the multiplier has been cut in half - therefore making the current stimuli less effective than in the past.

U.S. Money Multiplier



Source: St. Louis Fed

The length and extent of the low interest rates policies and fiscal stimulus have created distortions whose effect is to benefit certain investments over others.

Winners

• **Residential real estate:** The low cost of borrowing increases the ability of potential buyers to pay. This slowed the fall of home prices in the U.S. and contributed to their rise in Canada;
• **Bonds:** The decline in interest rates increases the value of bonds as investors are willing to pay a premium for securities that pay higher coupons than newly issued bonds;
• **Companies with high dividends:** Faced with declining yields on bonds, investors seeking income have turned to high dividend stocks. The demand for these securities has led to an appreciation of their value;
• **Gold:** Low interest rates have reduced the opportunity cost for holding gold while demand increased due to the increased risk of inflation and currency devaluation.

Losers

• **Investors:** Interest rates that are lower than inflation jeopardize the realization of investment objectives;
• **Pension funds:** The calculation of the present value of pension annuities relies on current interest rates. Lower rates increase the present value of pension liabilities, therefore worsening the solvency of pension funds;
• **Insurance companies:** Life insurers have similar problems as pension funds for their annuity business. They also obtain lower yields on reserves they use to pay claims while the present value of future claims increases with lower interest rates. This in turn greatly affects their profitability and balance sheet.

PORTFOLIO MANAGERS
9001 L'ACADIE BLVD, SUITE 401, MONTREAL (QUEBEC) H4N 3H5
T 514.385.9001 F 514.385.9002

The stimulus measures that have been implemented are exceptional and their effect on public finances certainly makes them unsustainable. We can imagine that less accommodative measures would likely result in a reversal of the winners and losers.

Implications for portfolio management

Monetary and fiscal policies are difficult to predict accurately over time. Many try but very few manage to be successful with any degree of consistency. We believe that this approach is futile and that it is much preferable to focus on one important pillar of capitalism: profitable companies that are able to appropriately identify and fulfill the needs of their customers.

We advocate a value approach based on fundamental analysis. For us, profitability and solvency are necessary conditions. Among companies with these characteristics, we seek to invest in those whose valuations are the most reasonable.

Without a doubt, the past five years have not been enjoyable for equity investors. However, the 2008 crisis did not only have negative repercussions. In fact, it has notably resulted in a more judicious use of leverage, as evidenced by the improvement in the balance sheets of companies over the past five years. In addition, with respect to profitability, many companies have significantly reduced their cost structures - particularly in terms of manpower and financing - resulting in improved margins. With respect to valuations, the crisis and bleak economic outlook have increased uncertainty and fear among investors. As a result, many favoured fixed income at the expense of equities. The result: numerous companies are now trading at much lower multiples than in the past. In light of these observations, we believe that these improvements provide a solid foundation to the stock market for the coming years.

The fundamental analysis we perform is at the origin of our investment decisions. You will find below a summary of some major themes connected to our portfolios:

Equities

The securities of companies and income trusts perceived as more defensive and sporting high dividends have done very well recently and now trade at higher multiples. We are gradually reducing our positions in these and reallocating the funds to other quality stocks selling at much more attractive levels.

Fixed Income

More than ever, we prefer securities maturing in the short term. We are able to improve current yields by favouring corporate bonds over government securities. The rationale behind shorter maturities is to preserve capital and to keep the option of redeploying funds at higher yields when interest rates do rise.

Asset allocation

What proportion of equities and fixed income securities should you hold in your portfolio? The answer depends on many factors and should certainly be based on a long-term strategy that is well aligned to your financial goals. Do not hesitate to contact our portfolio managers to review your situation and , if necessary, recommend pertinent adjustments to your asset allocation.