



**Agcapita Macro Update  
February 2010**

## Summary

Complacent, comfortable and sitting on an economic fault line - that's what I see when I visualize the West. Over the next 20 years as the baby boomers try to retire, the effects of the poor decisions our society has been making over the last 20 years will come back to damage the foundation of our affluent lifestyles. Why?

- Low savings rates – Western economies are heavily skewed to consumption with commensurately low savings rates while the emerging economies are skewed towards capital accumulation and have extremely high savings rates. China saves 40% of household disposable income, the US saves 6%. Only savings can create capital and because of this our capital pool is shrinking while the emerging economies' are growing. Capital, not consumption, drives growth so we should expect growth to continue to slow in the west and continue to accelerate in the emerging world.
- Inflation – The money supply in the west continues to grow more rapidly than any other time in history driven by fiscal deficits, currency interventions and bailouts. Financial assets tend to perform poorly in periods of high inflation and a large part of western wealth is tied up in these types of investments.
- Debt – Debt to GDP levels are at all time highs and growing. Unfortunately we have borrowed to support consumption so we have not created assets that generate cash flow to service our debts. Our options are tax, repay, default or inflate. Which do you think is most likely?
- Demographics – Aging populations and large unfunded social programs with a diminishing number of workers to pay for them. On top of this



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## Summary (continued)

we are increasingly competing with younger, well-educated work forces in emerging economies.

- Energy – Western lifestyles are dependent on low cost energy with the highest per capita usage on the planet (think – long commutes, large houses etc).

How do you protect your retirement in this environment?

- Protect and enhance your intellectual capital - continually strive to build unique, high value skills otherwise your only competitive advantage in the global market for services will be price.
- Protect the purchasing power of your savings and assets - place a portion of assets away from effects of local currency devaluation and inflation
- Energy price hedges
- Under consume and over-save
- Make demographics your ally and invest in countries that have young populations and high savings rates
- Start now – don't delay and don't rely on the government or house price appreciation to pay for it



# Global Macro Update

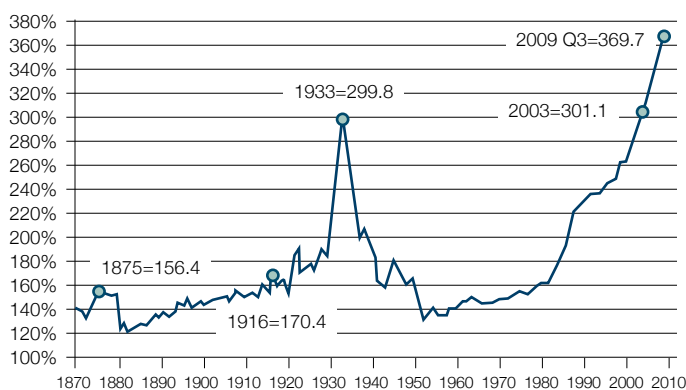
## SUBSIDIZING FAILURE – IS THIS REALLY THE PATH TO PROSPERITY?

Despite widespread belief to the contrary, government intervention into broad swathes of the economy to support “too big to fail” companies is not a positive for future growth. There is an economic truism that whatever you subsidize you get more of – hence by subsidizing failure we are ensuring bigger failures in the future and worst of all penalizing well run businesses. The firms that were prudently managed leading up to the crisis should have benefited from the demise of their poorly run competitors – in a free economy capital would have flowed to the profitable businesses rather than the loss making ones. The fact that this didn’t happen creates a perverse “if you can’t beat ’em, join ’em” mentality with respect to risky and imprudent business practices.

## DEBT TO GDP

Up and away into the wild blue yonder...

CHART 1: TOTAL US DEBT TO GDP



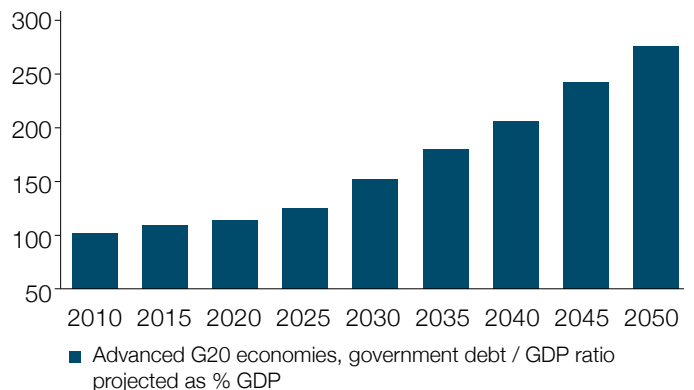
Source: BEA, Federal Reserve and Census Bureau

The situation is not much better in most other western nations. Chart 2 shows the impact of unfunded social obligations for ageing populations across the developed world.

## INFLATION THE INSIDIOUS, HIDDEN TAX

Just 3% annual inflation over the course of a 45-year working career can cause a 75% reduction in the purchasing power of your money. Of course, inflation has been running much higher than a “mere” 3%. The US government, like most others, regularly recalibrates its inflation indicators to make the numbers seem less alarming. Chart 3 highlights the disparity between the CPI-U produced by America’s Bureau of Labour Statistics and the SGS Alternate CPI produced by Shadow Government Statistics using older, less massaged methodologies.

CHART 2: IMPACT OF AGING



Source: IMF

## Global Macro Update (continued)

As you can see, over the past 20 years, prices have been rising much faster than government numbers would have you believe. If you are searching for a possible explanation for such a disparity Marc Faber summed it up succinctly when he said, “*Never ask the barber if you need a haircut. Never ask the realtor if the house you are considering buying is a bargain at the price offered. And never ask the government to calculate the rate of inflation when it can save millions of dollars in cost-of-living adjustments.*”

In addition to a general erosion of purchasing power, inflation also has another more insidious effect. Because inflation does not happen in the aggregate – does not increase the price of all goods and services at the same rate at the same time - inflation benefits the groups who have first access to newly created

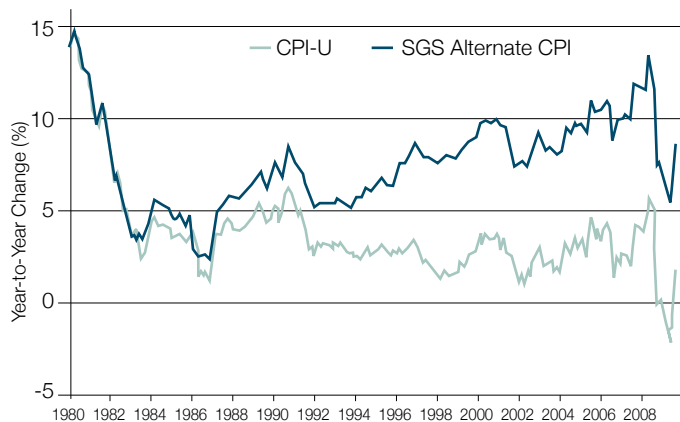
money and inflating asset classes versus the rest of the participants in the economy. The net result is that wealth is redistributed from the inflates to the inflators.

### THERE’S NO GOD-GIVEN GIFT OF A ‘AAA’ SOVEREIGN DEBT RATING

As has been predicted by the extensive financial crisis research of Kenneth Rogoff, sovereign credit ratings are coming under pressure as fiscal deficits grow rapidly and tax bases shrink. The following is some anecdotal evidence of this trend.

- **Portugal** - “*If Portugal wants to avoid a downgrade, it is going to have to take meaningful, credible steps to get the deficit under control,*” said Anthony Thomas of Moody’s credit rating agency. *Financial Times* - January 10, 2010
- **Iceland** - Standard & Poor’s put Icelandic debt under negative credit watch after Iceland’s president blocked a bill of compensation for the failure of Icesave bank. The agency said “*as a result, we could lower our ratings on Iceland by one to two notches within a month*”. Fitch credit rating agency downgraded Iceland’s long-term debt rating from BBB- to BB+ citing a “*renewed wave of domestic political, economic and financial uncertainty.*” *The Telegraph* - January 6, 2010
- **France and United Kingdom** - Fitch Ratings warned Britain and France that they risk losing their AAA status unless they map out a clear path to budget discipline over the next year. *Telegraph* - December 22, 2009
- **Mexico** - Standard & Poor’s reduced Mexico’s credit rating one notch to BBB from BBB-plus.

CHART 3: CURRENT GOVERNMENTS  
CPI V. SGS ALTERNATE

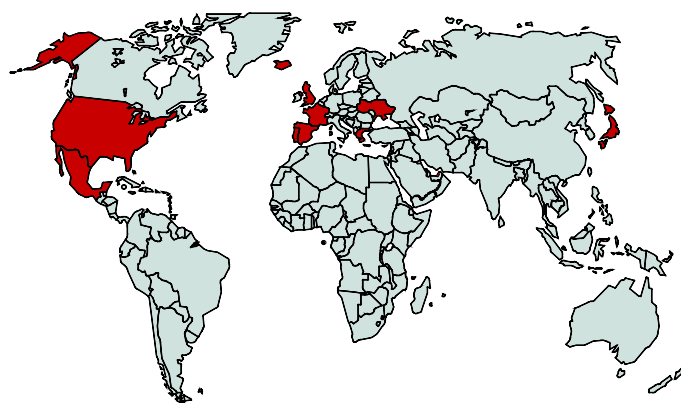


Source: John Williams’ Shadow Government Statistics

## Global Macro Update (continued)

- The cut came after Fitch cut the country's credit rating one notch to BBB. This was Mexico's first downgrade in over 10 years. *Reuters - December 14, 2009*
- **Dubai** - Moody's said that its rating downgrades reflect the weakening in Dubai's economy and the repercussions on its banks' asset quality and earning power. *Reuters - December 10, 2009*
  - **Spain** - Standard & Poor's cut Spain's credit outlook to negative from stable. "*Reducing Spain's sizable fiscal and economic imbalances requires strong policy actions, which have not yet materialized,*" according to Standard & Poor's. *BBC News - December 9, 2009*
  - **Greece** - Fitch cut Greece to BBB+, outlook negative. Fitch said its move was due to "*concerns over the medium-term outlook for public finances given the weak credibility of fiscal institutions and the policy framework in Greece.*" *Wall Street Journal Online - December 8, 2009*
  - **United Kingdom and United States** - Moody's said U.S. and U.K debt ratings may "*test the Aaa boundaries*" because public finances are worsening in the wake of the global financial crisis. "*The deterioration has been pretty severe,*" said Pierre Cailleteau, managing director of sovereign risk at Moody's. *Bloomberg - December 8, 2009*
  - **Japan** - Moody's removed the Japanese government's last triple-A foreign currency credit rating. The agency described the move as a largely technical one but also said Japan was in a worse position than many other governments in its top ratings bracket. *Reuters - May 18, 2009*
  - **Ukraine** - Standard & Poor's cut Ukraine's credit rating two levels to the lowest in Europe. Ukraine's long-term foreign currency rating was lowered to CCC+, seven levels below investment grade. S&P left the outlook negative, indicating a possible further cut. *Bloomberg - February 25, 2009*
  - **United States** - John Chambers, the chairman of Standard & Poor's sovereign ratings committee said pressure is building on the "AAA" rating of the United States. Chambers said "*There's no God-given gift of a 'AAA' rating, and the U.S. has to earn it like everyone else.*" *Reuters - September 17, 2008*

CHART 4: GLOBAL SOVEREIGN DOWNGRADE WATCH



## Global Macro Update (continued)

### YUAN IS NOW THE LINCHPIN OF THE GLOBAL FINANCIAL SYSTEM

The US has been exporting inflation with China's cooperation for over a decade via China's fixed exchange rate with the dollar – eventually all the dollars, Euros, loonies etc that China has been absorbing will come home to roost causing global inflation. Although, the Chinese government keeps the Yuan artificially depressed and appears set to do so for the immediate future, the Yuan ultimately will be revalued causing a severe downturn in the currencies of its trading partners. As part of the revaluation process China will stop buying US treasuries causing interest rates to increase rapidly. Though US demand for Chinese goods might rapidly decelerate this could be offset by a large increase in the domestic purchasing power of the Chinese economy and a large reduction in input costs for Chinese companies (commodity prices will fall in Yuan terms) – domestic growth could accelerate in China.

### US CURRENT ACCOUNT DEFICIT WITH \$200 OIL?

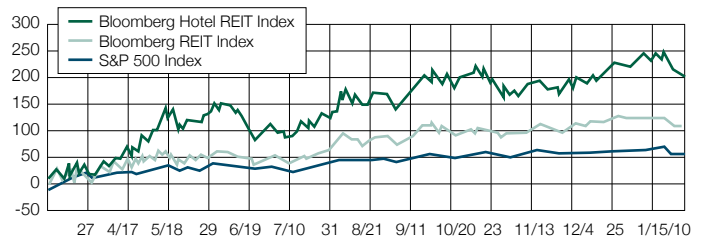
Assuming 10 million bopd of imports, \$200/bbl oil would add US\$ 438 billion per year to the US current account deficit. That would increase the deficit by approximately 4% of GDP on top of already historically high levels – how would the US fund such a deficit and sustain its way of life?

### US OVERSIGHT COMMITTEE SAYS, “MOST SERIOUS WAVE OF COMMERCIAL REAL ESTATE DIFFICULTIES IS JUST NOW BEGINNING”

Real Estate Investment Trusts (“REITS”) values increased steadily from 2000 to 2007 then fell sharply

as underlying commercial real estate prices began to drop in late 2008. Once the bailout funds began to flow in 2009 REITs recovered rapidly and have more than doubled from the stock market lows of last March.

CHART 5: REITS VERSUS S&P 500 INDEX



Source: Agorafinancial.com

This presents something of a paradox as the NCHREIF commercial real estate price index shows that underlying commercial property prices have fallen almost 40% and do not appear to justify such a recovery – in fact the evidence strongly supports the conclusion that conditions are still deteriorating.

In the spirit of sublime understatement the latest Congressional Oversight Panel (COP) report stated that the “*most serious wave of commercial real estate difficulties is just now beginning*”. The report is an interesting read but here are some excerpts from the summary for those disinclined to read the entire document:

## Global Macro Update (continued)

**“Over the next few years, a wave of commercial real estate loan failures could threaten America’s already-weakened financial system.**

*The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation’s mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy.”*

**Between 2010 and 2014, about \$1.4 trillion in commercial real estate loans will reach the end of their terms. Nearly half are at present –underwater! – that is, the borrower owes more than the underlying property is currently worth. Commercial property values have fallen more than 40 percent since the beginning of 2007. Increased vacancy rates, which now range from eight percent for multifamily housing to 18 percent for office buildings, and falling rents, which have declined 40 percent for office space and 33 percent for retail**

*space, have exerted a powerful downward pressure on the value of commercial properties.*

*A significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American.“*

Is this prediction overly pessimistic? Japan’s experience with a commercial real estate collapse is informative. Chart 6 shows that that land prices fell 87% over the last 20 years from their peak in 1990.

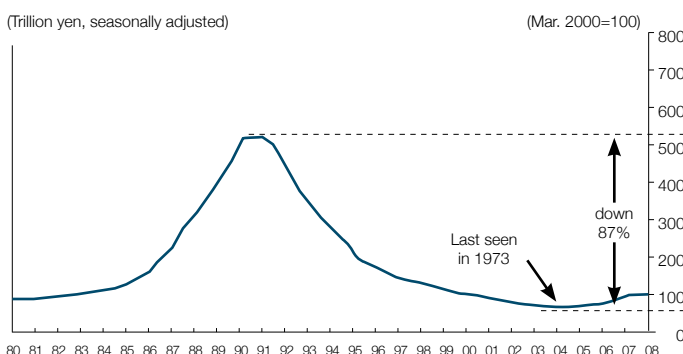
### WHO DO MAINSTREAM INVESTMENT FUNDS ACTUALLY BENEFIT?

Michael Lee Chin founder of mutual fund company AIC Limited recently stated, “Let’s look at the history. If over the past 14 years you had invested \$10,000 in the best CI mutual fund, that would have earned you \$41,000, had you owned CI stock that derives its money from revenue generated from that fund, that \$10,000 [would be] worth \$164,000.”

According to Lee-Chin, the best AGF fund over the last 14 years was the AGF precious metals funds - \$10,000 invested in that would now be worth \$35,000. But owning AGF stock would have given you \$56,000. Investors Group’s best fund would be worth \$26,000, [while] shares in IG would be worth \$63,000.” Summary return data:

- CI mutual fund - \$41,000 - return 22%
- CI stock - \$164,000 - annual return 22%
- AGF mutual fund - \$35,000 - annual return 9%
- AGF stock - \$56,000 - annual return 13%
- Investors Group mutual fund - \$26,000 - annual return 7%
- Investors Group stock - \$63,000 - annual return 14%

CHART 6: JAPANESE LAND PRICES



Sources: Cabinet Office, Japan Real Estate Institute



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