

# Opportunity to be found

## Global economy will prevent a deep recession

PAUL GARDNER

Now that Alan Greenspan has been retired for more than a year, popular opinion has started to turn against him. Criticism of the former U.S. Fed governor revolves around what many consider his true legacy as father of the “bubble” economy. This criticism is a result of hindsight analysis of the Federal Reserve under his direction, and the aggressive easing that was undertaken during times of economic weakness.

On the surface, these opinions may seem correct. However, if we search for an understanding why the Fed seems to be “repeating its mistakes” by easing interest rates in today’s market turmoil, it becomes apparent that this avenue may be unavoidable.

Is today’s Fed cycle of easing just another example of an over-reaction by the Fed and the Bank of Canada?

The central bank’s role, through monetary policy, is to ensure that the rate of inflation is contained, the economy expands at a non-inflationary pace and the industrial capacity of the economy fulfills or exceeds that economy’s cyclical demand. The secondary role of the central bank is to ensure that no “shocks” prevent the economy from running smoothly. This second role is where there is the possibility of conflict between saving the economy and creating a bubble.

The biggest fear for a central banker is that if a depression sets in or a liquidity crisis occurs (such as in August, 2007), public sentiment and the expectations of society can change drastically (think of 9/11). This could mean companies delay purchases of equipment or unions negotiate inflationary wage contracts. These two examples can affect the state of the economy much more dramatically than changes to interest rates.

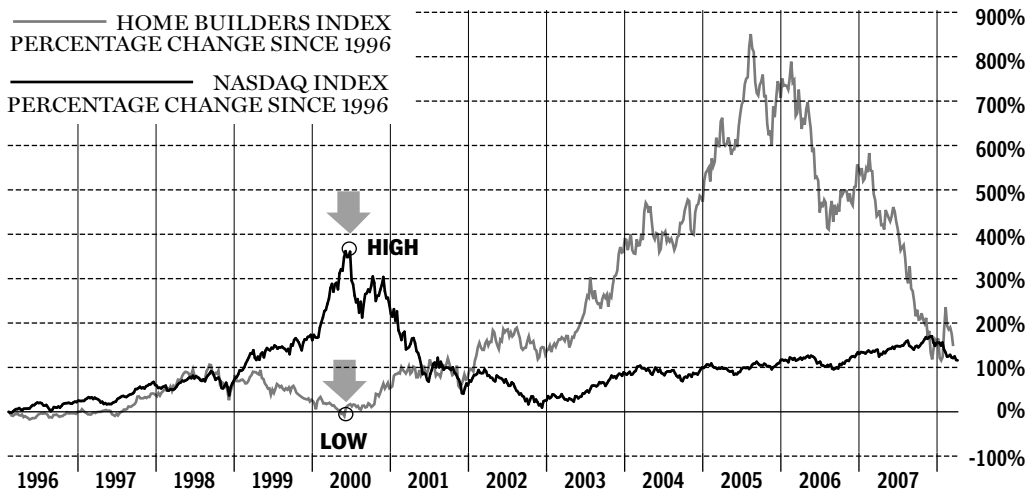
Expectations are critically important, especially the public’s expectations of recession or inflation. In 1974, it was not the oil shock that caused inflation; it was wage inflation running at more than 10%. It is very hard for a central banker to change the mindset of a consumer or labourer when that sentiment sets in.

The Fed’s aggressive easing, in the now-famous Tech Bubble, was to reassure companies and consumers to keep buying equipment and to spend in order to keep productivity high and the economy afloat. That scenario is being repeated today to counter the moribund U.S. housing market. The Fed is not worried about capital destruction. It is not its concern if commercial banks or private-equity firms want to lend money for risky assets. *Caveat emptor.*

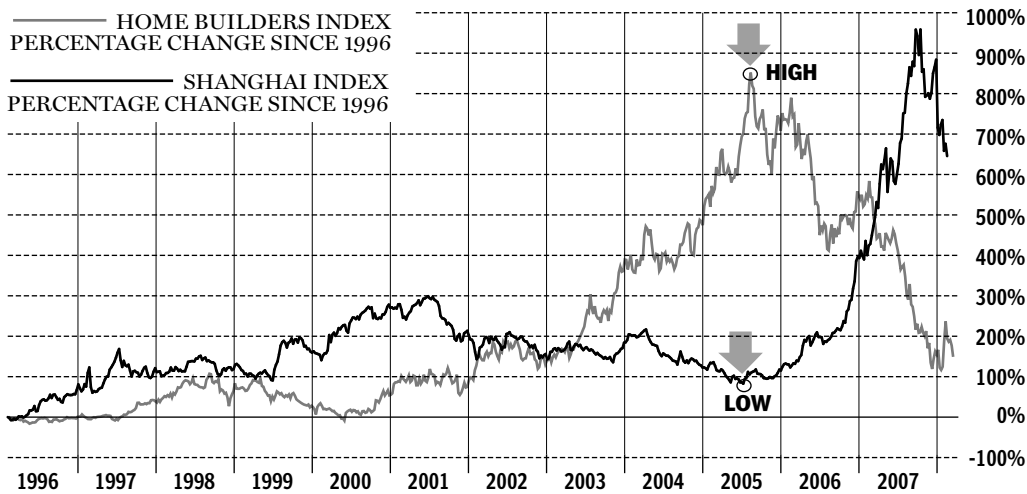
Japan, in the late 1980s, was an example of poor government and misguided central bank intervention. Japan’s housing and equity bubble clearly had to break. In 1989, Japan’s Royal Palace, on paper, was worth more than the island of Manhattan. The Japanese equity index was approaching a whopping price-to-earnings multiple of 62. Clearly, Japan’s market authorities had to do something, and they did. They raised overnight rates aggressively, hiked lending requirements and tightened spending. They succeeded in collapsing speculation, but they kept monetary policy tight even after the bubble burst. In addition, the

## WATCHING FOR THE NEXT BUBBLE

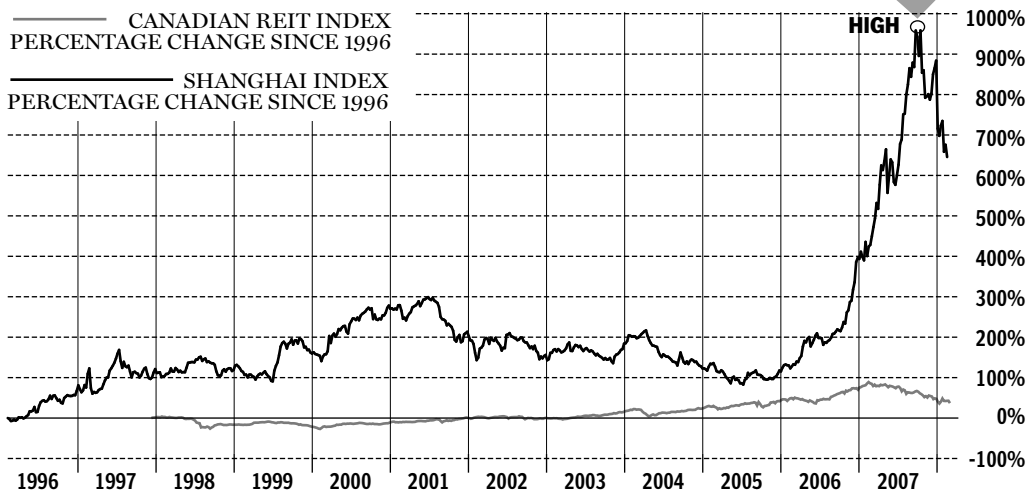
When all the rage was “Clicks & Bricks,” sending the NASDAQ to new heights, investing in bricks and mortar, as evidenced in the Home Builder index, was out.



As the boom in subprime mortgages caused speculation in real estate to flourish, the Chinese “economic miracle” story was starting to unfold to create the next bubble.



With share prices of the Shanghai Stock Exchange now trading at an average valuation of 40 times earnings, making them expensive, is the Canadian Real Estate Investment Trust sector where the next bubble might be forming?



SOURCE: AVENUE INVESTMENT MANAGEMENT AND REUTERS

RICHARD JOHNSON / NATIONAL POST

Japanese government spearheaded a move to increase its consumption tax rate in 1996. All these actions caused the Japanese economy to go into recession mode. Japan is still fighting a depressive mood today.

The Great Depression was the ultimate example of establishing negative sentiment. After the stock market crashed, the U.S. government increased restrictions on commercial banks, which caused restrictive lending. As well, Washington became protectionist and established new trade barriers that restricted trade. The result, as we all know, was 10 years of depression until massive government spending occurred because of the Second World War.

Unfortunately, when one cures a patient there are sometimes side effects. The side effect of aggressive monetary easing is a bubble, but in the end the disease has been cured.

With regard to today’s situation, the economy cannot be put into a deep recession or depression due to a new aspect of macroeconomics: the global linking of economies. The “fast” money that had access to “easy” credit has to be washed away, and at some future point normal valuations and liquidity can be restored. The contrarian investor can actually profit from bubbles by taking advantage of what

remains after the carnage.

With the charts above to help illustrate, here is an example of the bubble phenomenon in action, using recent history as a guide. The Nasdaq hit a zenith when technology stocks were all the rage, but the real estate and construction sectors, as evidenced in the Home Builder index, were undervalued.

However, as the boom in subprime mortgages caused speculation in real estate to flourish, the Chinese “economic miracle” story was unfolding to create the next bubble. As the Shanghai index reached

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a stunning price/earning multiple of 40 times, where might the next bubble come from? Given that at this very moment the central banks are creating massive liquidity (and real negative interest rates) the Canadian REIT sector might provide the answer.

At our firm, we tend to be value focused in our investment style. We like bubbles when there is a Federal Reserve ready to act. Bubbles are, in essence, a wild misalignment of capital.

A “bubble economy” results in other sectors being starved for capital. Valuations in these other sectors are out of favour, depressed and therefore cheap. This allows vigilant investors to take advantage of this serial behaviour. During the tech boom, you could not find anybody in investment meetings who would talk seriously about oil & gas companies or REITs that yielded 13%. The market would look at you as “old school” and talk about how “bricks and mortar” were being replaced by “clicks and bits.”

Today, you could make a compelling argument that Canadian REITs are “starved for capital” since funding costs (i.e. credit spreads) have gone much higher or are not available due to the U.S. crisis. Fundamentals are still very strong for this sector, with occupancy at record highs and equity discounts that trade far below Net Asset Value (NAV). Remember, the property market is in much better shape here than the United States.

In the end, the bubbles of the past, present and future will always punish the investor with a “herd” mentality and reward the patient contrarian who sees the misalignment of capital as a buying opportunity.

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