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Why Excessive Government Debt Is
More Affordable Than It Looks 'For Now'

As investors, we need to pay attention to the potential fallout from deficit spending that has gone too far in many countries. There are risks associated with this (as we see today in Europe) and also important interest rate implications. Apart from Greece (which has no hope of repaying most of its debt) and certain European nations (where high bond yields indicate some default risk) most debtor nations have a reasonable amount of time to deal with this issue. This is due to the fact that interest rates (on the majority of government debt) are incredibly low. For example, in the U.S. and Canada, average government bond yields are only about two percent. Low interest rates are bad for conservative savers but are needed to buy time for many fiscally challenged governments.

At today's low rates, the U.S. Government spends an affordable thirteen percent of government spending financing its debt. In Canada, it is just eleven percent. Years ago, when Canada faced its debt crisis, Canada had to spend a whopping forty three percent of government spending on bond interest alone! While our debt to GDP ratio was high at that time, the main reason it was so costly to service debt was that interest rates back then were a lot higher than today. After some austerity, growth in the economy, and lower interest rates, our federal debt to GDP ratio declined substantially.

Even Europe (as a whole today) has the capacity to service its debt, due to low interest rates in the majority of European countries. However, we do not know if European governments have the political will to prevent a 'domino default scenario' in weaker European nations. If the debt crisis spreads, this will no doubt have nasty effects on financial markets. Some progress has been made although recent elections in Greece and France are once again showing how fluid and unpredictable this situation is. Fortunately though, the bulk of the world's debt-challenged governments (such as U.S., Japan, UK, Quebec and Ontario) have time to deal with their debt problems due to interest rates being so low.

We expect interest rates to remain artificially low for some time as inflation is under control and central banks are more concerned about excessive government debt and promoting economic growth, than fighting inflation, which fortunately remains low. Low interest rates are good for financial markets as investors and pension funds have to use corporate fixed income, stocks and real-estate, to make any reasonable return going forward. This in turn creates buying demand which can influence investment values higher.

Our approach to portfolios has been to have a 'normal' (close to) fifty percent allocation to stocks, though it varies by client according to age, risk appetite and tax situation. We are overweight global stocks due to lower valuations, the strong Canadian dollar, and our contrarian bent. We are also using medium-term corporate fixed income to lock in "reasonable" interest rates. The average investor has been shifting to corporate fixed income in recent years, but has been reticent to buy stocks due to memories of the bad downturn in 2008. Some investors have added to Canadian stocks but when it comes to U.S. and international stock investing, individual Canadian investors have sold more than they have bought for the past four years. Buy high, sell low has historically described the flow of investing funds from individual investors. We will do our best to do the opposite.

Over the past year and half, global stocks (particularly U.S.) have been outperforming Canadian stocks, so this has helped our relative returns; and we are not suffering from low interest rates due to our medium-term fixed income approach. We have very little invested in short-term fixed income as we anticipate a prolonged period of reasonably low interest rates. We are underweight resource stocks (which has helped in the past year) and are being careful with bond issuer quality in case financial markets experience a nasty decline that spreads into the corporate debt market.

Clients have portfolios that are designed to provide reasonable longer term returns and we are controlling for 'risk' by using very high quality equities and fixed income. We are as comfortable as we have ever been with investment quality of what clients own. If bad times materialize, we can shift some of our safe fixed income into what will be very cheap equities.

To conclude, low interest rates will likely be with us for some time. The Bank of Canada will likely raise rates a bit over the next couple or years but given our high dollar and 'ok but not great' economy, don't expect a return to normal interest rates for some time. Also, don't expect U.S. interest rates to increase to four percent from today's two percent, as at that level, government spending on interest goes way up to twenty six percent from thirteen percent… and the fallout on their economy and deficit would be bad… so why do it?

In this low rate environment, financial market performance should be fine over the longer term, but we remain very cognizant of the need to control risk for our predominately retired clientele.

What else is going on?

1. Good news on TransGlobe, an apartment REIT owned in number of client accounts. It is being taken private at 15.5% premium to its previous share price, and almost twenty percent higher than its twenty-day average share price. As it is trading very close to the $14.25 per share offer, the market assumes the deal will go through (at $14.25). Some clients hold the debenture as well or instead; we will continue to hold it for its decent 5.4% interest coupon.

2. We keep seeing ads from a large Canadian insurance company advertising 'guaranteed stock market related mutual funds' that Canadians can retire comfortably on, head to a beautiful beach and sip cool drinks without worry. We wish they mentioned the very high (unseen) 3.5% plus management fee and mentioned how the so-called guarantee works (which in my opinion is worth little). When it comes to investments that look too good to be true, they are too good to be true.

3. Most large U.S. companies have just reported quarterly earnings and about two thirds have beaten earnings expectations. Companies in general are in the best shape we have seen in years. Concerns over China and Europe have overshadowed these positives, so markets are weak of late.

4. We have a pretty good handle on estate planning issues so please don't hesitate to ask for help on this matter. Basic estate planning includes granting 'Power of Attorney' (before one becomes mentally or physically unable to do so without court approval), ensuring an up-to-date will is in place, using beneficiary designations, using joint accounts (great between spouses, generally not with children until late stage heath issues occur with one surviving parent), use of inter vivos trusts (trusts set up in your lifetime, which occasionally work well

but only for a very small part of our clientele) and use of easy-to-implement testamentary trusts through a will update (great for many high net worth clients who have adult children). Testamentary trusts are something we have started discussions on with some clients and we will continue to look for situations where we think a client can benefit. Insurance solutions can also at times be effective but it really depends on the circumstances, age, and health situation. Using insurance to eventually pay out corporate holding company investment proceeds is very effective tax-wise.

5. CIBC Wood Gundy has beefed up its ‘business succession planning’. Clients with a business who are thinking or retiring or selling in the next few years should take advantage of this free and effective advice.

6. Clients checking their accounts online occasionally see their accounts’ total value affected by an investment that (within the month) is temporarily priced at zero. This is sometimes due to a re-registration process. The bottom line is that if you see a sharp drop in your account value (online) and financial markets are ok, it is probably due to this issue. Generally, it is fixed in a day or two and we virtually never see this issue affect a month end statement.

7. We got a tip from a client that we wish to pass on. If you have children who are 19 or older and have no taxable income, they should still file an income tax return as we believe that may make them eligible for up to $175 of HST credit per quarter. Go to http://www.cra-arc.gc.ca/bnfts/gsthst/fq_qlfyng-eng.html for more details.

8. We have updated our team’s website. Please check it out at www.thepopeteam.ca and perhaps save it under ‘Favorites’. You can also access your accounts online through that site by clicking ‘Client Login’ near the top right hand corner. (Please call Cheryl or Melanie if you would like to be set up for online access.) Tell your friends about our ‘exciting’ team website and help us try and rival Facebook and iTunes in online searches… ha ha.

9. Our team member Vivi had a healthy new baby girl named Gemma. Vivi is off on one year’s maternity leave. We have two new (adult) additions to our flock at the office, Olesya who is originally from Kyrgyzstan and Cindy who is originally from Taiwan.

Regards,
CIBC Wood Gundy

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Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors.

TransGlobe Apartment REIT is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months.
CIBC World Markets Inc. has managed or co-managed a public offering of securities for TransGlobe Apartment REIT in the past 12 months.
CIBC World Markets Inc. has received compensation for investment banking services from TransGlobe Apartment REIT in the past 12 months.
CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from TransGlobe Apartment REIT in the next 3 months.

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