WEBB ASSET MANAGEMENT

May, 2009

# Monthly Commentary

SYSTEMATIC, PROVEN & RELIABLE

## Commentary

### The Surfer and the Tsunami

There has been much talk of green shoots in the economy lately. At the very least there does seem to be some evidence that things are not getting worse. Housing prices may have stabilized, credit spreads have narrowed, the banks passed the stress test, China is growing and earnings have not been as bad as feared.

Both the stock and bond markets are pointing to a recovery. In the case of stocks, the US market is up approximately 42% from the intra-day low of March 6th, 2009 and up 4% YTD. For bonds, the 10-year US Treasury bond yield has increase from 2.1% on 12/31/08 to 4.9% today. The yield curve has steepened from 180 bps to 460 bps. Economic theory suggests that a steepening yield curve confirms a recovering economy as the bond market is sensing an increase in demand for credit. However, there might well be a darker side to the steepening of the yield curve. Perhaps the bond market is signaling that rates must go higher due to the massive increase in US Treasury debt issuance? The words "trillion-dollar deficits" now just seem to roll off our tongues. Up until now, I had never used the word "trillions" except in astronomy class. Deficits have to be financed with debt, and debt has to be repaid with tax receipts. Issuing US Treasury debt was easy and was done at low yields when everyone wanted riskless assets and were in fear of deflation. Going forward, issuing massive amounts of US Treasury debt might not be so easy and will most likely be done at higher yields. The largest natural buyers of US Treasuries, the Chinese and Japanese, no longer need a place to park funds from their massive trade surplus with the US. In addition, tax receipts are falling and the interest expense is rising. The mere fear of inflation will get yields to move higher.

The media is fixated on the recovery of the economy but seems to be missing the big story: trillions of dollars of new debt and newly printed money. It reminds me of the story of the excited surfer who can only see 100 yards to the perfect wave but can't see the tidal wave that's just a ½ mile off shore. What does trillions in new debt mean? What does a doubling of the money supply mean? The super hero 'helicopter Ben' has morphed into an armada of carpet-bombing 'B52 Ben'. Most of us, including the government itself, do not know the ramifications of this amount of monetary stimulus. But be sure there will be ramifications. And given the staggering amount of money involved, the ramifications will be large and most likely in the form of inflation and currency devaluation.

When I started managing money in Canada in 1994, I used to ask people what Canada's largest export was? Some would say oil, others cars, others rocks and trees. I would answer that it was debt. In the early 90's, the Canadian government was running massive deficits to fund its generous social programs and had to issue new debt just to pay the interest on the massive amount of debt outstanding. To entice buyers to purchase that new debt, the Bank of Canada had to keep raising interest rates and let the currency slide. Rising interest rates further choked off economic growth, which in turn lowered tax receipts, which in turn forced the government to issue more debt. Canada was caught in what Goldman Sachs called the vicious 'debt spiral'. Is this what the rise in US interest rates might be fore telling? Right now, all the federal taxes collected from people west of the Mississippi are used just to pay the interest on US Treasuries. That line is quickly moving east!

Lastly, I leave you with some thoughts on the General Motors bail-out. At a measly $60 billion, it is a microcosm of the trillions that are being wasted. The US government has put $60 billion in GM for a 60% ownership stake. 2005 was the peak year of profitability for auto companies worldwide but GM managed to lose over $2 billion that year. Experts say that if absolutely everything went right, the best GM could ever make going forward would be $5 billion. At the top of the cycle, auto companies generally trade at 5 times earnings, so GM's best market valuation might be $25 billion. Thus under the best-case scenario the tax payers' investment in GM should lose 75%. But it gets better. Though GM currently has only 40,000 workers, it provides pensions to 650,000 people and health care to 1 million people. Like Social Security and Medicare, these costs are only likely to go up and remain out of control. So, how much of that $60 billion investment will actually be returned to tax payers? Most likely none. Given the staggering numbers that are being thrown around, the only things that seem to make sense are hard assets. The only way out for the United States is monetary inflation to wipe out the ballooning debts. Thus, we continue to focus our capital on commodity companies with rising earnings and companies that will continue to benefit from the growth in China and India.

*-Derek Webb*



Webb Asset Management Canada, Inc.

Telephone: USA (415) 229-3180 Canada (416) 601-2449 Toll Free (866) 611-9590 | 26 Wellington St. E Toronto, Ontario M5E 1S2 | info@WAMfunds.com www.wamfunds.com