



# The Bottom Line

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## Bet You Things Are Better Than You Think

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There is increasing reason to believe that the worst of the financial crisis is behind us and the U.S. and global economies are bottoming. I believe we will see moderate growth in Canadian and U.S. GDP by year-end, a far cry from the recent contractions of more than 6%. There certainly remain many doomsayers who argue that all manner of economic and financial calamities will befall us, but I would suggest that most of these concerns are either unfounded or premature. Indeed, at the start of this year, virtually no one would have believed that the stock markets would be up roughly 25% from their lows within two months, that consumer confidence would be rising along with house sales and oil prices would have risen to nearly \$65 a barrel. Even some leading indicators of employment conditions have improved, although the net number of new jobs is still falling in the U.S. It does appear, however, that the pace of decline is slowing.

Financial conditions have improved meaningfully as monetary and fiscal easing do their stuff. Credit spreads have narrowed, the VIX and the TED spread are much lower and liquidity has improved. Even some of the troubled banks in the U.S., most notably Bank of America, are able to rebuild capital by issuing common equity.

To be sure, we remain in a very difficult restructuring process to reduce leverage and excess capacity in many financial and nonfinancial sectors, but optimism that we will avoid a systemic breakdown has increased. The Chrysler bankruptcy appears to be going better and more swiftly than some had feared, which bodes well for the coming GM bankruptcy. The auto sector will continue to have enormous negative repercussions for economies in North America (and elsewhere), but the job is finally getting done following countless years of inadequate adjustment and faltering change. The stakeholders have all now been forced to capitulate to the reality of the situation, which can only be positive in the longer run.

The process of deleveraging and restructuring is very painful and it is a multi-year process that will have long-term consequences of reduced potential growth. Clearly, however, the kind of growth we experienced the decade before the crisis was unsustainable. Many now are warning about coming inflation, a downgrade of U.S. debt, devaluation of the U.S. dollar and the loss of U.S. reserve currency status.

Absolutely, the Fed and the fiscal authorities cannot run the printing presses to pay for ever-increasing budget deficits indefinitely, but they are well aware of that. It is happening all over the world in response to the crisis, and it has been a necessary response. But with the proper monetary adjustments, even the shift from huge contraction to modest growth will meaningfully reduce the federal deficit in the U.S. Even the recent stock market rally helps; unless bears are correct and it does turn out to be a false start, capital gains tax revenues will rise. But it is unlikely, in my view, that the market will return to its lows of early March because the underlying fundamentals have improved.

As Moody's reaffirmed the triple-A rating of U.S. government debt with a stable outlook, hopefully the fear of a U.S. downgrade and ultimate default dissipates. I know the textbooks might argue that the stimulus is inevitably inflationary. However, given so much excess capacity, the likely reversal in policy after growth picks up, the very low chance of wage pressures leading to a 1970s wage-price spiral, and the relative strength of the U.S., the U.S. dollar is unlikely to fall precipitously. In fact, Canada and even the U.S. look outright buoyant compared to the slump in Continental Europe and Japan. There is no comparison between the U.K. gilt market and the U.S. Treasury market regarding liquidity, stability and base-level ability to fund the debt. There is no other currency or country in the world that could play the role of the U.S.—not now, and probably not for at least a decade or maybe much more. These bearish sentiments are healthy. We need to be worried about these issues. But pent up demand and enormous liquidity, coupled with mammoth global stimulus, will turn the economy around sooner and more dramatically than most people now think.

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