

WILL THE CURRENT FINANCIAL CRISIS TRIGGER A NEW WAY OF THINKING ABOUT THE ECONOMY?

The United States of America inaugurated its 44th presidency last week on the backdrop of an unresolved banking crisis and a fast-accelerating recession. This already is a presidency of firsts with very high expectations for change. Investors should however focus on the profound changes in policymaking that will likely emerge from this crisis. These could alter the very underpinnings of economic policy in the U.S., in the UK and by extension, globally. This edition of the Marker analyzes the current shift in thinking, and its potential impact on markets and the economy.

THE GREENSPAN ERA

During his two decade tenure as Chairman of the Federal Reserve, Alan Greenspan earned wide applause for helping the world emerge from multiple economic and market crises. History may however come to judge the defining realization of the Greenspan era to have been an unrelenting movement toward deregulation and less government intervention. Mr. Greenspan took over the Fed Chairmanship during the summer of 1987. Under his leadership, the Fed consistently argued for reduced government intervention and lower taxes (two areas beyond the Fed's control), while making aggressive use of monetary policy to counter economic challenges brought about by important events, including Black Tuesday (October 1987), the S&L Crisis, the Asian Crisis, LTCM, the Tech Wreck of 2000, and 9/11. Chairman Greenspan's influence over public economic policy proved effective regardless of the party in power. The repeal of the final elements of the Glass Steagall Act occurred during the democratic administrations of Bill Clinton and led to seismic changes in the global banking industry. Modifications to mortgage-market regulations facilitating the disastrous changes in lending practices were made during the two-term republican presidency of George W Bush. Both serve as potent examples of the *Maestro's* reign atop U.S. economic policy making. Globalization and relentless pressure by the U.S. to encourage freer trade and less government intervention in emerging economies around the world also were hallmarks of the Greenspan era. In a December 14, 2008 New York Times Magazine article¹, Robert Skidelsky, a Keynes historian and author, makes an insightful comment on a striking confession from Mr Greenspan. In essence, he quotes Mr. Greenspan as saying the intellectual foundation of his economic thinking - that self interest would serve as an auto-regulation mechanism - had crumbled under the evidence of behaviour during the mortgage crisis.

BACK TO KEYNESIAN DOCTRINE

John Maynard Keynes made an extremely worthy contribution to economic policy thinking by stating that government intervention was required in order to counter the potentially destructive effects of free markets gone wild. Under his influence, western world governments moved to deficit spending, which contributed to the inflation-riven 1970's. Today, with the economy in a global recession and banking systems in disarray, leading voices in the U.S., the UK, and Canada are calling for greater government intervention. Governments realize that interest-rate policies have run their course of effectiveness. Fiscal and spending measures are now required. The new administration in the U.S. has already announced massive spending on infrastructure, and we should expect tax cuts aimed at middle and lower classes to be enacted in the coming weeks. The most recent federal budget in Canada brings 11 consecutive years of surplus to an end, providing instead for a cumulative \$85 billion expected deficit over the next five years.

NATCAN MARKER

The prevalent switch in economic thinking is leading to the first countercyclical spending program in the U.S. since 1980. It will entail greater government intervention in the form of regulation. The coming months will be dominated by a tug of war between deflationary forces set loose by economic de-leveraging and inflationary forces in the form of government stimulus. Policy makers and general observers who clamor for greater government intervention and regulation will get what they wish for. For investors, this could mean a sea change in the analytic framework that will need to be applied in order to be successful.

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FINANCIAL MARKETS

RETURNS AS AT JANUARY 23, 2009 (%)	MTD	QTD	YTD	RATES AS AT JANUARY 23, 2009	
S&P/TSX	-3.78	-3.78	-3.78	CAD/USD	1.25
S&P 500	-6.74	-6.74	-6.74	CAD/Euro	1.60
S&P/TSX Small Cap	-1.19	-1.19	-1.19	US Treasuries yield 10-yr/30-yr	2.62/3.33
Russell 2000	-9.99	-9.99	-9.99	GOC bond yield 10-yr/30-yr	2.82/3.66
MSCI EAFE	-12.48	-12.48	-12.48	Fed Fund Rate (target)	0.25
MSCI World	-9.17	-9.17	-9.17		
DEX Universe Bond	-0.20	-0.20	-0.20		

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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¹ Robert Skidelsky, "The way we live now; The Remedist." *New York Times Magazine* - nytimes.com, December 12, 2008.