NATCAN MARKER

June 23, 2009

BUDGET DEFICITS, MONETIZATION AND INFLATION

The Obama Administration appears to pursue a dual agenda. On the one hand, it must address the most important economic challenges in a generation. On the other, it is determined to enact a vision of the U.S. economy for which it won office. Both translate into important spending measures of concern to investors. In this edition of the Marker, we review the risks related to deficit spending.

CURRENT AND FORECAST DEFICITS AND APPROPRIATE MEASURES

Government deficits are by nature massive in absolute terms, typically ranging in billions ($50 billion forecast for 2009-2010 in Canada) and trillions of dollars (in the U.S.). The only valid measure of government deficits however is relative to the size of a country's economy, which is itself measured by GDP. Just as a lender determines how much mortgage debt a borrower can expect to repay (approximately 30% of disposable income is the benchmark), the size of a country's deficit and debt load need be viewed in light of the total resources available to repay debt.

Once measured along these lines, recent U.S.-projected deficits appear no less daunting. For this year, the estimate is 13% of GDP, a level only previously reached in war time (WW II). Total public debt stood at 41% of GDP at year end 2008. Ironically, this was the same level as 20 years prior (1988), which means one needs to apply some perspective: though higher in dollar terms, the U.S. has not lost ground as a debtor over the past two decades.

Deficit forecasts are however of great concern. The current administration has stated it intends on running deficits of such levels for several years to come, so as to implement its vision of the future for the U.S. economy, while fighting the current crisis. It is precisely the perspective of a government providing support to automobile production, banking and insurance while implementing fundamental and costly reforms of the health care system and new environmental policies that has markets so concerned.

INVESTOR FEARS AND REACTIONS

Those fears are the core of recent actions by global investors. Economic theory dictates that governments faced with ballooning deficits have two ways of correcting the situation. The first is to grow the economy, thereby generating greater revenues to meet debt obligations. The other is to allow inflation to do the job by reducing the value of debt. Students of history know that across time, governments in hock have always resorted to inflation as the easier way out of debt problems. This is euphemistically referred to as "monetizing debt".

Investors are implementing measures to protect themselves from future government-sponsored inflation in two key ways. First, they are demanding higher yields on longer term issues. In essence, they are telling the U.S. Treasury they require a higher insurance premium against future inflation. The second reaction observed is that investors are pushing the value of the US dollar down, acting on their belief that inflation will erode the value of U.S. goods and assets.

Recent investment measures taken by the country's largest creditor, China, are indicative of this trend. While it cannot sell massive amounts of U.S. assets, China has been changing the mix of its holdings by moving to shorter maturities (less impacted by increasing inflation) and moving away from agency debt, into Treasury notes with maturities well inside five years.

NATCAN MARKER

The Obama Administration is acting aggressively to mitigate the effects of the current recession, while also implementing its visions of desirable change to the social programs fabric. It is not the first time a new governing party has adopted such a stance. Many administrations – namely, Bill Clinton in his first term - experienced painful demonstrations of the power of a bond market pressed to defend its interests. History demonstrates something must give. In the short term, fears of credit downgrades in the U.S. may be overdone. We should expect adjustments to party spending platforms once the current leadership is reminded of the risks of taking on bond vigilantes.

Michael Quigley, CFA, CAIA
Senior vice president, Distribution

FINANCIAL MARKETS

RETURNS AS AT JUNE 19, 2009 (%)	MTD	QTD	YTD
S&P/TSX	-0.63	18.80	16.42
S&P 500	4.34	4.49	-3.67
S&P/TSX Small Cap	0.32	23.97	19.40
Russell 2000	6.38	9.50	-3.53
MSCI EAFE	2.69	12.83	-1.04
MSCI World	3.01	8.82	-2.32
DEX Universe Bond	0.50	0.39	1.92

	RATES AS AT JUNE 19, 2009
CAD/USD	1.13
CAD/Euro	1.58
US Treasuries yield 10-yr/30-yr	3.79/4.53
GOC bond yield 10-yr/30-yr	3.52/3.97
Fed Fund Rate (target)	0.25

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.

This publication is intended for your personal use. The information and opinions herein are provided for informational purposes only and are subject to change based on market and other conditions. The views expressed should therefore not be relied upon as the basis of your investment decisions. Past performance is not necessarily indicative of future performance. This document is not and should not be construed as a solicitation or offering of units of any fund or other security in any jurisdiction. No part of this publication may be reproduced in any manner without the prior written permission of Natcan Investment Management Inc. All market index returns presented in this commentary are expressed in Canadian dollar terms and were provided by Thomson Reuters, Standard & Poor's, a division of McGraw-Hill Companies Inc. and PC-Bond, a business unit of TSX Inc, unless other specified.

N A T C A N