LONGWAVE GROUP

Ian Gordon Economic Forecaster & Interpreter of the KONDRATIEFF CYCLE

Those who cannot remember the past are condemned to repeat it. Santayana

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WINTER WARNING

A Man of Constant Sorrow

U.S. Treasury Secretary Tim Geithner's recently revealed Financial Stability policy initiatives can be likened to a failed launching of trial balloons due to insufficient helium. Mr. Geithner's income tax controversy during his confirmation hearing, notwithstanding, his initial attempt at designing a major policy initiative was deemed by the marketplace to be a dog's breakfast. Basically, Mr. Geithner outlined a three point template which was long on guidelines, but short on specifics, to wit:

- An initiative to provide banks with more equity, but with government input regarding disbursements, dividends and executive compensation.
- A $1 trillion (U.S.) public / private bailout fund to encourage private investors to buy troubled bank assets.
- A plan to expand the government's Term Asset-Backed Security Loan Facility (TALF) to foster a restoration of the securitization market.

Currently, there is a consistent theme which echoes through the offices of the U.S. Capitol, the White House and the American media that somehow, somewhere, there must exist a government plan to "*fix the financial system*" or, "*kick start bank lending*" or, "*get people back to work.*" Few people seem to realize or understand that recessions and depressions are natural occurrences within the long term business cycle. There is no quick fix, magic trick or potent elixir to turn the course of events on a dime. As Mr. Geithner is now discovering, there is neither a politician (no, not even U.S. President Barack Obama), nor, a government mandarin of Churchillian stature and leadership presence to halt the incoming tide of economic depression.

So, the Treasury Secretary reaches out to the private sector for some answers and ideas, only to be greeted with a blank stare. Although the banking system is in dire need of massive injections of private sector capital, this will remain a steep uphill challenge, unless losses from bank toxic assets are realized in some fashion, such as nationalization. There appears to be no shortage of economists advising the Obama administration that the U.S. economy will begin to recover in the second half of this year. We believe this mindset constitutes a pipedream of wishful thinking.

Your First Loss Is Always Your Smallest

In a recent information leak to the Montreal newspaper *La Presse*, the Caisse de Depot et Placements du Quebec, Canada's largest pension fund manager, reportedly lost $38 billion (CAD) in 2008, due primarily to lower equity prices. Preliminary figures disclosed that the value of the Caisse's investment portfolios declined by $155.4 billion (CAD) to $120 billion (CAD), or by 26% during the year (not including $3 billion (CAD) in contributions). The losses mean that the average annual return over the last decade is a mere

4%, compared to the 7% the Caisse requires to meet its obligations. A sector breakdown revealed that the Caisse's equity and fixed income holdings declined by $26 billion (CAD), foreign exchange losses totaled $5 billion (CAD) and write downs on its non-bank asset backed commercial paper (ABCP) investments were $4 billion (CAD).

Investment executives, portfolio managers, fixed income and equity traders employed by the Caisse are well compensated, supposedly experienced, knowledgeable and well trained. However, by embracing a primary investment strategy of broad diversification, it would appear that Caisse investment managers failed to recognize, not only, deficiencies in non-bank asset backed commercial paper, but also, macro economic data and technical indicators that were signaling an imminent market downturn. Indeed, last December Caisse management admitted a fundamental reliance upon the rating agency DBRS for its decision to hold investments in ABCP, instead of doing their own due diligence.

Also, from a technical perspective, the pension fund manager missed a key bear market signal from the Dow Jones Industrial Average (DJIA) and the Toronto Stock Exchange – S&P/TSX Composite Index, particularly in May, 2008. At that point, with the DJIA still hovering at the 13,000 level, shifting into a bear market strategy would have saved the Caisse billions of dollars. Indeed, we can only wonder to what extent defensive positions in gold investments and government bonds would have mitigated Caisse pension fund losses.

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