

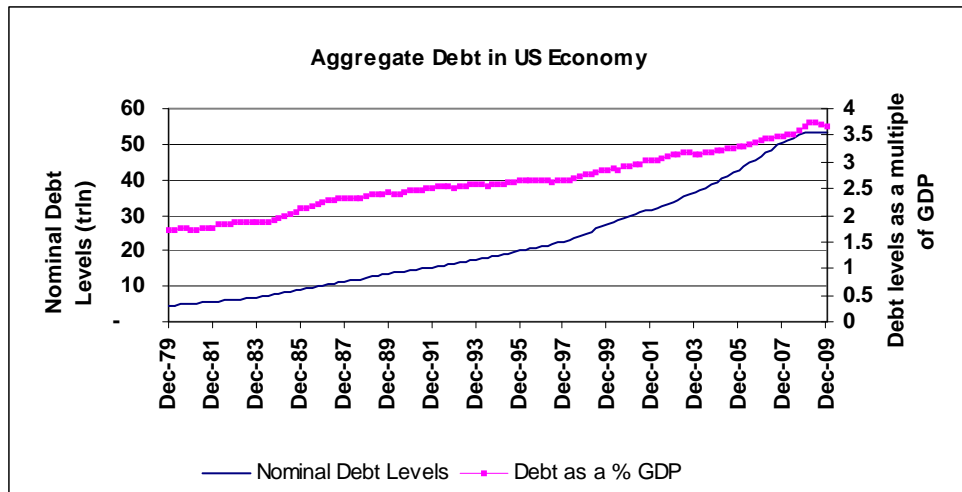
LEITH WHEELER INVESTMENT OUTLOOK



Second Quarter 2010

Are We Drowning In Debt?

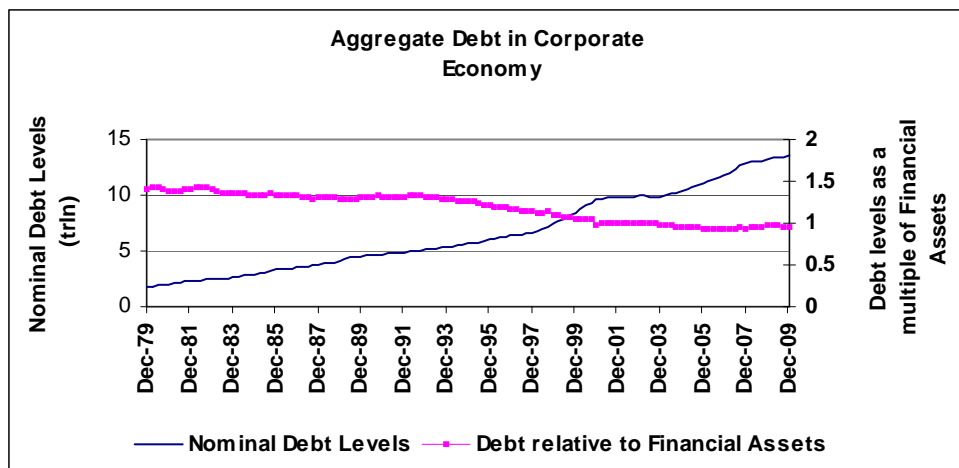
According to headlines, the amount of debt in the North American economy, in both dollar and percentage terms, is at a precarious level. The following chart for total debt in the U.S. economy is frequently cited as proof of these concerns as both debt measures are at, or near, record levels.



The implication is that the modern economy is built on tenuous footings and that investors should protect themselves from potential deleveraging through investments such as gold or other precious metals. However, the problem is not as simple as the picture suggests. There are four components to total debt (corporate, consumer, banking, and government) which do not all reflect the message sent by the aggregate debt measure. We will examine each component and look at its investment implications. A fair amount of the analysis will focus on the U.S. where historic data is more readily available, and wherever possible we will look to explain differences with the Canadian economy.

Corporate Debt

Let's start by splitting out the proportion of debt attributable to corporations. The following chart shows the aggregate debt of U.S. corporations and then looks at these same debt levels relative to the financial assets owned by U.S. corporations.



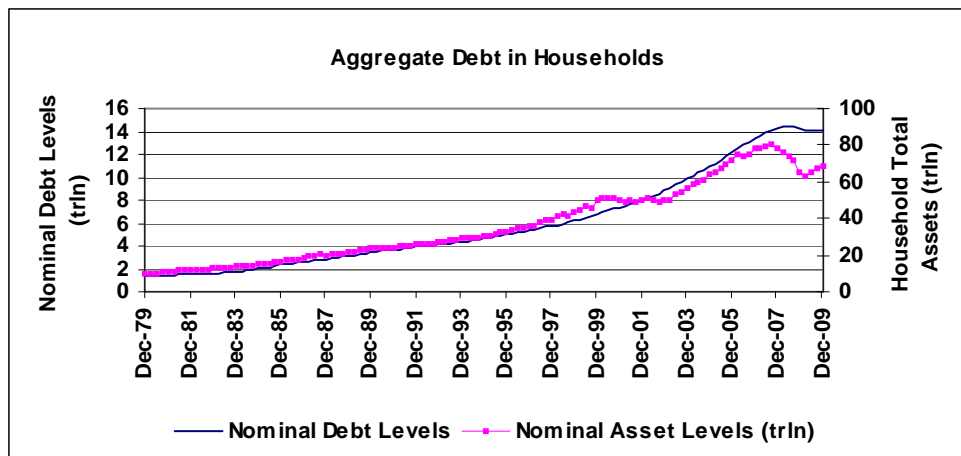
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Overall, the corporate balance sheet is somewhat less levered than 30 years ago, as relative debt levels have actually decreased. In fact, one of the hallmarks of this recession has been the comparative strength of corporations. Clearly, corporate debt levels are not extreme when compared to history. What is masked by looking at the total debt is the distribution of corporate leverage. Prior to the recession, we saw a much higher percentage of issuance from more highly levered / lower rated entities. This resulted in a record number of defaults in 2008 and 2009 - not much of a surprise given that the historical record shows the highest chance of default on newly issued, lower rated debt is several years after issuance. With the return to debt issuance over the last few months, especially lower rated debt, we could see that defaults of these most levered firms surge higher in several years time.

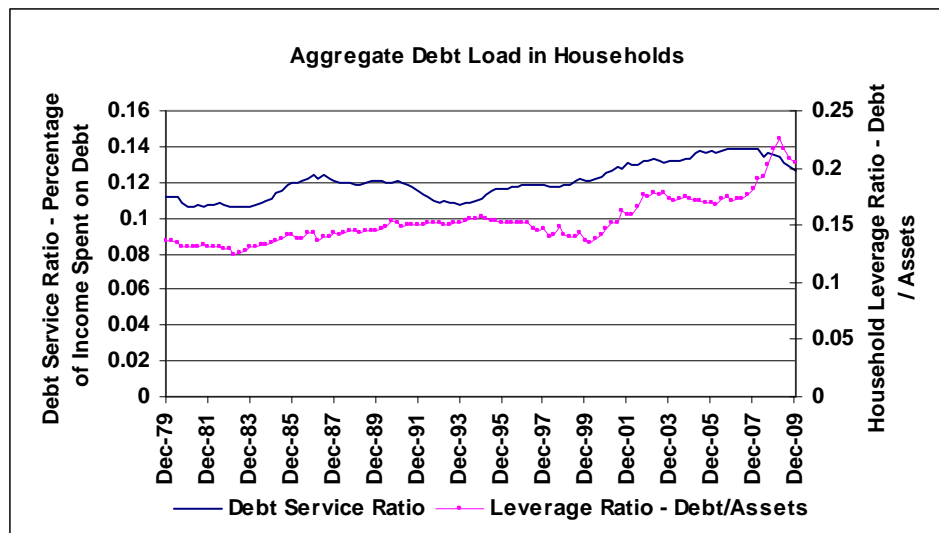
Consumer Debt

A lot is said about the impact of the recession on the over-levered consumer. In isolation, consumer debt levels do paint a picture of excessive spending. However, what sometimes gets missed in these assessments is the significant surge in household asset levels. The following chart shows the level of household debt on the left hand axis compared to the level of household assets on the right hand axis.



In effect, consumers were increasing their debt at the same pace that their asset values were increasing. Products such as home equity lines of credit allowed consumers to supplement their spending by accessing the increased value of their house. Unfortunately, as house values have fallen, a larger proportion of the population has seen their leverage ratio climb uncomfortably high. These debt levels are getting normalized through debt pay downs where possible and through default and liquidation where not.

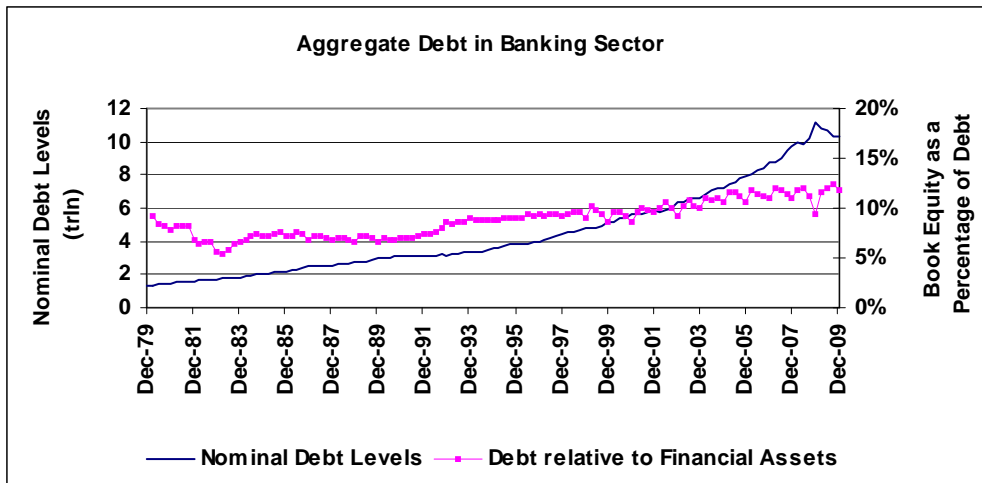
A final measure of consumer leverage looks at the debt service ratio. This measure is intended to capture the share of household after tax income committed to debt repayment. Below you can see that the actual cost to service consumer debt has not significantly increased over the last 30 years. Most recently we have even seen a slight improvement in the ratio as consumers have reduced debt due to uncertainty around job prospects and the economy in general.



Despite commonly held beliefs that Canadians are much more financially conservative than Americans, most of the measures we have looked at are consistent across North America. The key difference has been recent real estate performance, where U.S. residential real estate values have dramatically underperformed Canadian counterparts. This has impaired household asset levels in the U.S. relative to their Canadian counterparts.

Banking Debt

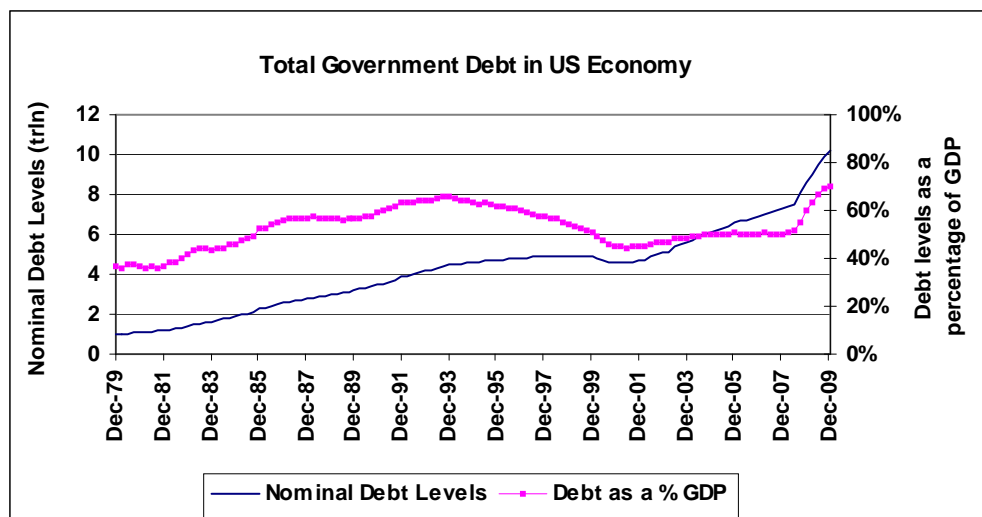
The third category of debt is termed financial debt. This area has increased substantially over the last ten years. There are two trends to note with this increase. The first chart looks at the level of equity on bank balance sheets supporting this debt.



In effect, throughout the last ten years, banks were retaining a portion of their profits and allowing the amount of debt outstanding to drift up to maintain a similar debt ratio. The second main trend has been the role of securitization and non-bank financials in increasing debt. These areas have had the impact of transferring debt to many different investors. Areas that have traditionally relied on securitization such as levered loans, commercial real estate and sub prime lending will need to transfer back to traditional bank funding sources at more elevated financing costs.

Government Debt

The final area of concern for the explosion in total debt is government debt. Over the last several years we have seen an unprecedented increase in deficits and debt levels across developed countries. This has been most pronounced in the US where government debt, as a percentage of the US economy, has risen back to levels not seen since the Second World War. In effect, government stimulus and bailout programs have resulted in shifting the pain of declining asset values from bank and consumer balance sheets on to the government balance sheet. In reality, government has decided to spread the near term costs from the significant economic dislocation across generations of taxpayers through higher debt levels.



This increase in debt has raised concern and caused some market participants to worry about a buying strike that could cause U.S. government bond yields to sky rocket. We believe that the chance of a Greek type buying embargo in the U.S. is quite low. Studies have shown that there is no magic level of government debt that triggers a crisis. Japan has the lowest yields in the developed world and a debt level that is twice as high as the U.S. is forecasted to reach. What differentiates the U.S. from Japan is the U.S. reliance on international funding of their debt. Whereas Japan had some of the highest saving levels to rely on, the U.S. increasingly funds their debt abroad. The main providers of these assets are Japan and China. As China maintains a fixed currency relative to the U.S. dollar, they are required to stabilize their substantial trade surpluses by buying foreign financial assets. As long as the U.S. is able to maintain a reasonable level of economic growth, their credit will continue to look attractive relative to other alternatives such as Europe.

The one impetus from these higher deficits seems to be a swing back to fiscal restraint. With the impact of the current stimulus package running its course over the next 12-18 months we should expect the positive tailwind from government spending to turn into a head wind for economic growth. The second impact of the government response has been to highlight the longer term structural problems in government accounts. In the U.S., this is exemplified through social security and Medicare costs (entitlements). Within Canada the pressure will come from the costs of advancing medical treatments for an aging population. These trends have only three long term solutions, none of which are politically palatable: cutting entitlements and medical costs, cutting other government programs to pay for entitlements or increasing taxes. In reality we should expect a blend of all three to deal with these concerning trends.

Investment Implications

First off, corporate leverage levels imply that corporate debt from most issuers represent reasonable investments. There is nothing concerning from a structural standpoint about corporate debt levels. That being said, security selection is critical to weed out the corporations that have used the current cheap leverage to take on more debt than they will be able to manage going forward.

In terms of consumers, we should expect a resumption of consumer spending but most likely not at the levels seen during the last 5-7 years. A significant portion of pre-crash consumer spending benefited from increasing asset values, such as home equity withdrawal. As these trends have reversed, we should expect spending to move more in line with consumer income.

As the economy improves, the financials should experience a gradual decline in bad debts. One of the most likely consequences of increased regulation will be a requirement that banks hold a higher portion of equity to protect against credit write-downs in the next credit cycle. We should also expect, on average, higher costs of funding in areas of the economy that benefited most from securitization and cheap credit, such as lower quality real estate loans.

Finally, increased government debt is expected to put upward pressure on real interest rates. That combined with business cycle pressures will most likely cause nominal bond yields to drift higher over the next couple of years. Overall economic growth is also expected to moderate as governments move away from record stimulus to more fiscal and monetary restraint.

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