FINANCIAL POST

Saturday, June 19, 2010

While bulls and bears clash, the wise win

Michael Nairne, Serious Money

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Instead of designing a portfolio around one or another future scenario, investors are better served by understanding their capacity to take risk and building a long-term, well-diversified portfolio they can live with.

There is a great debate going on among money managers that has enormous ramifications for affluent investors.

On one side, the bears argue that the bill for a three-decade orgy of borrowing in Western society has now come due. That the massive monetary and fiscal stimulus by governments only postponed the day of reckoning and that the deflationary forces of deleveraging will eventually overwhelm the current recovery.

They predict that in the next downturn, like the emperor with no clothes, governments will have no resources to re-inflate the economy. Mammoth debt defaults and an excruciatingly painful mini-depression are, they say, inevitable. The bulls counter that recovery has more momentum than the bears admit and that the bears underestimate the curative powers of a long-lasting, expansive monetary policy.

They admit that many Western governments are overly indebted, but point out that many are already moving to exercise restraint.

What the bears miss, they argue, is that the locus of growth for the world economy has shifted to China, India, Brazil and other developing countries -- nations with strong balance sheets and a growing middle class. Also, U.S.

multinational corporations, which are sitting on mounds of cash, are perfectly positioned to capitalize on this new reality.

Both sides pore over every economic release to bolster their case.

The bulls note that the U.S. Federal Reserve's Beige Book report indicates that all regions in the United States are now expanding.

Old news, respond the bears. More relevant are the sharp fall in retail sales and the disappointing U.S. jobs report in May.

Dig deeper, counter the bulls. Weekly payrolls and hours worked were up nicely in May. The bears celebrate every weak number; the bulls cheer every strong one.

Meanwhile, the stock market swings back and forth -- a hypersensitive gauge of who seems to be winning the debate.

Both camps admit we are at a juncture in history that has no parallel. Never have so many governments been so indebted and so burdened by promises of lifelong pensions and free medical services to aging populations.

At the same time, never have so many people in the developing world had such an opportunity to advance their standard of living so quickly.

As Tony Boekh concludes in his excellent book, the *Great Reflation: How Investors Can Profit From the New World of Money,* no one knows exactly how the recent efforts by advanced countries to stimulate their economies will turn out.

Maybe governments will be successful in re-engineering a durable recovery and will be afforded the time to restructure their finances. And maybe not. What is clear is that investors face a wide range of possible outcomes.

Not surprisingly, the recommended portfolios of bears and bulls are very different. As one talented and bearish hedge fund manager said, when the next crisis is triggered -- he is currently fretting about the enormous public debt of the U.K. -- investors will want to be long in cash, Canadian government bonds and gold, and short in about everything else.

Meanwhile, a bullish global strategy team is recommending corporate bonds, U.S. small company stocks and Asian equities, while shorting gold, an asset they believe is badly overbought.

Wise investors know that nobody has a crystal ball. Instead of designing a portfolio around one or another future scenario, they are better served by understanding their capacity to take risk and building a long-term, well-diversified portfolio they can live with, regardless of who finally wins the debate.

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