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Exuberance and the US\$

Spring of 2009, what fabulous markets we enjoyed. Sure, the economies continued to look awful, but with so many pension and mutual fund managers, individuals as well of course, feeling performance anxiety, the markets only had one way to go, and that

was up. With this the future recovery in the global economy was discounted at a very early stage, dare one say too early? With this early start, how will the markets react on the day economists officially declare the recession over?

In the kind of speculative market we saw, companies with no profits appreciated the most. One penny stock we kept an eye on lost 90% last year. It traded at the low throughout winter and into spring, and then, within days almost, it appreciated by 900%. Impressive as this sounds, this only brought it back to the level it was before it fell over the cliff. There were no material changes in the company's business, it keeps losing money just as fast as before, what happened was that cheap money found a seemingly cheap asset and irrational speculation followed.



What worries us is the extreme swing in sentiment we witnessed. From the gloomiest gloom we went, almost overnight, to indiscriminate hope. All the talk of deflation was replaced by fears of (hyper) inflation. Presuming that America did not care about the value of its currency, a run on commodities ensued.

Indeed, the market seems to take a lot of guidance from the fortunes of the US\$. With a debt now standing at over 50 trillion dollars and growing, it may look tempting to debase the currency. While from the debtor's point of view this might be an attractive proposition, the creditors see it differently.

Creditors can also not be happy not to be paid for buying US debt. At a given point holders of US debt will demand to be rewarded for holding the debt, and they will not accept a devaluation of the US dollar. Will America listen? Most likely it will not have a choice in the matter, for as the world's largest debtor, it can ill afford to ignore its bankers. China and Russia have already spoken about the need for America to protect the value of its dollar. As part of the spending programs in progress, America will need to continue raising huge amounts of money. It needs the goodwill of its creditors, and that goodwill comes with strings attached. If interest rates will not reward holding US debt, then a stable or rising US dollar is required. If that is not offered ... well one would rather not think of the consequences for America and us all.

By Rolf Spielmann, CFA
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Danger: Inflation ahead

The U.S. financial market has been engaged in considerable debate about the prospects for inflation, implicitly in trading action and explicitly in the “blogosphere”. The “doves” argue that the U.S. and global economies are quite weak and have been experiencing deflation. Indeed, the Federal Reserve Bank of St. Louis puts GDP at 6.4% below potential, the worst showing since the recession of 1982. The “hawks” meanwhile say the U.S. Treasury and Federal Reserve (“the Fed”) are throwing debt and money at the Great Recession as if there’s no tomorrow.

A broad money supply measure, M2, had been growing earlier this year at a 17% annual rate and still grows at more than half that rate. Monetary growth of 5% would be more consistent with stable economic growth. The U.S. federal debt is more worrisome. The Congressional Budget Office projects that the 2009 fiscal year deficit will be 13% and next year’s will be nearly 10%. Deficit spending has exceeded these levels in the past only because of World Wars I and II. And according to CBO projections, the federal debt will grow from 41% of GDP in 2008 steadily toward 82% in 2019. This debt load is unsustainable. (History suggests a sustainable amount of debt is 30% to 40% of GDP.)

And while the Fed will start the money and debt wind-down only after the economy begins to recover, it will act before the recovery is complete and inflationary pressures build.

While Blinder, as one of the smartest economists in the profession, makes a credible case, and the Fed has an army of highly qualified professionals to fight this inflation battle, whether the Fed will get the amount and timing of the money-and-debt wind-down correct is arguable. Given the current one-party control of the White House and Congress, political pressures to spend beyond the nation’s means remain high, witness new entitlement programs to come (universal health care) and existing programs that seem sacrosanct (Social Security, Medicare, Medicaid, Veterans Administration health system). It is difficult to see the nearly invisible efforts so far by the Obama Administration to contain the deficit. Keep watching. Inflation is around the bend.

By Matthew Gelfand, Ph.D., CFA, CFP®
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Princeton Professor and former Fed Vice Chairman Alan Blinder argues that inflation will be manageable. (See “Why Inflation Isn’t the Danger”, *The New York Times*, Sunday Business Section, June 21, 2009, p. 4.) The Fed is as likely to drain the money supply too quickly as too slowly, Blinder says. The Fed is well aware of the problems with the money supply and federal debt and has plans to manage the country out of the overhang.





Summer of '82

The more alert film buffs among you needn't worry: the title of this article has nothing to do with the movies (more specifically, that justly famous Robert Mulligan-directed opus, *Summer of '42*).

We simply wanted to draw a parallel between the current situation and the one that prevailed during the summer of 1982: there are several reasons to believe that March 9, 2009, bears comparisons to August 11, 1982, when the Dow flirted with the 772-point level.

By November 1982, the unemployment rate had hit 10.8%, and would remain above the 10% mark through much of 1983. During the first quarter of 1982, the U.S. GDP had shrunk by 6.40%—a decline of equal magnitude to that recorded this past spring.

The worst recession of the post-war era had officially begun in July 1981, under the Reagan administration—and it was declared over, just as officially, in November 1982.

The current bear market has taken the S&P 500 Index on a 12-year trip back in time. This is a rare event for the stock market: it has previously occurred twice, and in each case the market bottomed out soon after the free-fall began. That spectacular summer of '82 surge preceded the official end of the recession in November of that year, despite continuing high unemployment. The jobless rate was a so-called lagging indicator: economic activity, both in the U.S. and Europe, was showing signs of renewed vigour. In other words, there's nothing absurd about pegging the second quarter of 2009 as the beginning of the end of the current crisis Stateside.

That crisis has been with us, officially, since December 2007. That's 16 months, which happens to be the average duration of the "severe" post-war recessions. The end to the crisis is always preceded by a sharp rise in the indexes after the final low. The mega-meltdown in banks and stocks, which lasted for over six months beginning in September 2008, has inflicted lasting trauma on investors. But in this spring of 2009, some market indicators (the vast majority of contrary indicators along with some technical indicators such as Tobin's Q) have begun showing signals of a durable, extremely marked turnaround of stock market indexes, with the much-maligned financials leading the way to recovery.

Therefore, if our comparison is valid, equity indexes should, as they did in 1982, finish the year strongly. Extending that analysis further, we ought to be on the verge of a return to a long secular bull market.

But a comparison alone does not a prediction make. And the current situation has its differences: in 1982, the U.S. economy was emerging from years of double-digit inflation, marked by the famous Peak Gold, when the price per ounce topped out at \$850 US. Today, the inflationary risk is in front of us, not behind us.

Nevertheless, this mini-history lesson is there to help us put the current crisis into perspective by comparing it to more recent events—because all is not as bleak as it was in 1929. It must also lead us to choose flexible allocation managers with bullish outlooks for the coming months, and thus diversify the economic scenarios underpinning our portfolios. It's time to opt for managers who are sure that the worst is not yet to come.

By Luc Granger
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European news

Heavy job losses, consumption slows

The French economy destroyed nearly twice as many salaried jobs in the private sector in the first quarter of 2009 as in all of 2008, with a net loss of 187,800 positions (-1%), according to figures published recently by France's Institut national de la statistique et des études économiques (INSEE). The number of salaried jobs in the so-called "competitive" field (excluding agriculture and the public sector), which had declined by 100,500 last year, stood at 17.82 million at the end of March, these definitive INSEE figures show.

Most of the jobs destroyed since the start of the economic crisis have been those occupied by temporary workers, because the "exceptionally strong drop in the fourth quarter of 2008 is continuing," noted France's Direction des études du ministère de l'emploi (DARES). With 80,800 fewer jobs in the opening quarter of 2009 (-15.6% for the quarter and -34.3% for the year), the extent of the decline in temporary jobs is "unparalleled for the second consecutive quarter," DARES said. In both the industrial and service sectors, job losses worsened again in the first quarter (-1.5% and -1.2% respectively), while in the construction sector the decline was similar to that for the prior quarter (-0.7%). The situation is expected to persist for several quarters, with the French Ministry of the Economy saying the destruction of salaried jobs in the private sector in 2009 could reach the 591,000 figure predicted by the employment insurance system.

Source: lemonde.fr



House of Cards

A Tale of Hubris and Wretched Excess on Wall Street

By William D. Cohan

Doubleday

2009

Bear Sterns, what a wake-up call! One of their executives was quoted as saying that what happened was "24 hours from solvent to dead." That was of course six months before the collapse of Lehman Brothers in September 2008, an event which changed the financial world, and just about everybody's life, forever.

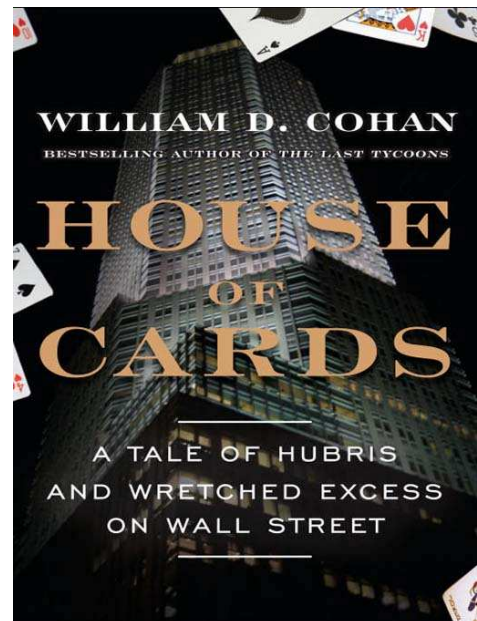
Although a public company since 1985, Bear Sterns saw itself as an industry outsider and the firm was always run more like a partnership. When Long-Term Capital Management collapsed in 1998, Bear Sterns was the only large firm refusing to step in and help. Memories are long, even on Wall Street, and this did not help when Bear Sterns ran into trouble itself and it had to accept the humiliation of being sold for only 2 dollars per share. Small consolation that later the price was changed to 10 dollars.

The tale Mr. Cohan tells is fascinating and he explains what went wrong and why. Egos played a huge role, which helps to understand how management could have let the balance sheet grow to as much as 50 times equity. Mr. Cohen outlines the dangers of putting all eggs into one basket, mortgage-backed securities in the case of Bear Sterns. When house prices started to tumble, clients and trading partners withdrew liquidity on a massive scale from Bear Sterns; a dangerous avalanche developed, arrested only when the government helped broker a deal for JP Morgan Chase to take over Bear Stearns.

Mr. Cohan describes how Wall Street, rolling in money, started to believe its own hype, forgetting just how fragile the foundations were on which the apparent success was built.

Those who warned senior management that the balance sheets were overleveraged had their careers cut short, for doomsayers were not to spoil the party. When reality hit, the former highfliers could not understand what hit them. James Cayne, the last chairman of Bear Sterns, cut a very sad figure as everything crumpled around him.

This is an interesting book that gives much insight into what went wrong on Wall Street. Mr. Cohan interviewed more than 120 people who lived through the collapse of the firm and the events leading up to it. A House of Cards indeed, Mr. Cohan's is a cautionary tale!



Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX	MSCI World
June 30	8447.00	3232.45	1835.04	919.33	10374.90	964.05
Monthly var.	- 0.63%	+ 0.94 %	+ 3.42%	+ 0.02%	+0.05%	- 0.61%
Year-to-date	- 3.75%	- 8.61%	+16.36%	+ 1.78%	+15.43%	+ 4.76%
Year-over-year	- 25.58%	- 34.67%	- 19.97%	- 28.18%	- 28.29%	- 30.77%

Index	FTSE	DAX	CAC40	SMI	Nikkei	Euro 50
June 30	4249.21	4808.64	3140.44	5403.97	9958.44	2401.69
Monthly var.	- 3.82%	- 2.68%	- 4.19%	+ 1.01%	+ 4.58%	- 2.02%
Year-to-date	- 4.17%	- 0.03%	- 2.41%	- 2.36%	+ 12.40%	- 2.03%
Year-over-year	- 24.47%	- 25.08%	- 29.19%	- 22.34%	- 26.13%	- 28.37%

Commodities	Gold	Copper	Crude Oil	Wheat	Lumber	CRB
June 30	928.30	228.00	70.11	580.00	211.90	249.96
Monthly var.	- 5.30%	+ 3.75%	+ 5.73%	- 8.98%	+ 10.54%	+ 0.05%
Year-to-date	+ 5.37%	+ 62.92%	+ 63.05%	- 5.54%	+ 24.79%	+ 13.21%
Year-over-year	0.00%	- 41.27%	- 50.04%	- 32.46%	- 12.44%	- 46.01%

Devises	\$CA	¥	€	£	\$AU
June 30	1.1630	96.35	1.4026	1.6450	0.8052
Monthly var.	- 6.55%	- 1.06%	- 0.93%	+ 1.61%	+ 0.52%
Year-to-date	+ 4.59%	- 6.05%	+ 0.47%	+ 12.83%	+ 14.21%
Year-over-year	- 14.09%	+ 9.29%	- 10.91%	- 17.40%	-15.99%

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