

## EXAMINING THE EUROPEAN DEBT CRISIS

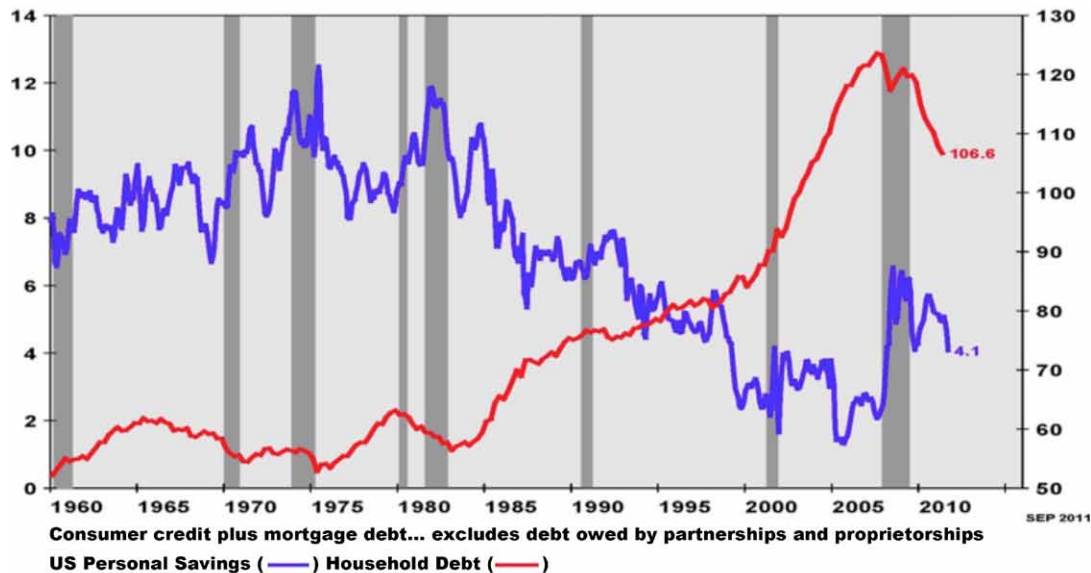
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*President and Chief Executive Officer*

January 2012

During the Sentry Investments Canadian Tour 2011 this past fall, a couple of themes dominated conversation: How does the US solve its budget problem and the directly related devaluation of its currency? Can the Europeans find a solution to their debt woes?

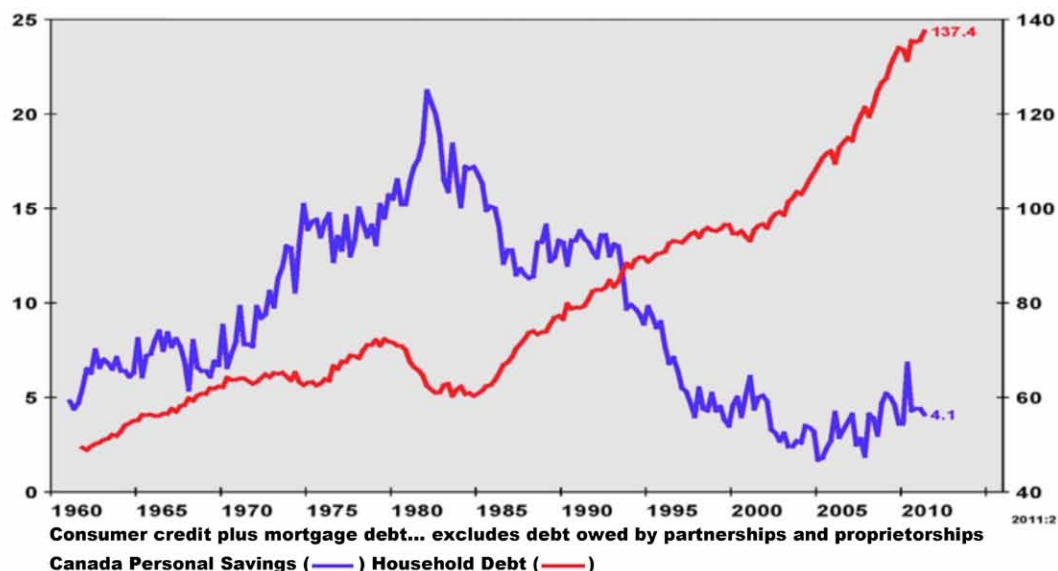
My initial response was that our concerns about what is happening elsewhere are a bit misplaced: we as a country are in little better financial shape than the Americans and Europeans. I have been referring in presentations to the fact that per capita debt in Canada is materially higher than in the US. Some have found this assertion to be odd given the media's overwhelming focus on the profligate Americans. Charts 1 and 2 are from John Aitken's (TD Securities strategist) recent chart package. Debt as a percentage of disposable income is 29% higher in Canada and our savings rate – which was materially higher in the 70s, 80s and 90s – has been no better (and frequently worse) in the 21st century.

**CHART 1: US personal savings and household debt as a percentage of disposable income**



Source: TD Securities, as at September 30, 2011

CHART 2: Canadian personal savings and household debt as a percentage of disposable income



Source: TD Securities, as at September 30, 2011

According to the International Monetary Fund (IMF), consolidated gross Canadian debt (federal, provincial and unfunded actuarial liabilities) represents 84.1% of gross domestic product (GDP). This is thanks to skyrocketing debt in Quebec (think Greece) and Ontario (think Spain). The comparable US figure is 100%. What is very clear from the IMF data is that advanced economies have an average debt-to-GDP ratio in excess of 100% while emerging economies have ratios closer to 40%.

Unfortunately, the US continues to spend at rates that increase the debt-to-GDP ratio much faster than in Canada. The US has a spending and revenue problem; the general government deficit as a percentage of GDP was 8% for 2011. Canada has the same problem but to a smaller extent: our deficit is 3.7% of GDP. When you add in contingent liabilities such as mortgages guaranteed by Fannie and Freddie, the US debt-to-GDP ratio balloons by another 35%, which should be reduced by the value of offsetting assets. The data for Canada Mortgage and Housing Corporation (CMHC) shows Canada guaranteeing loans worth 31% of GDP; given the high personal debt levels, this is an issue.

In meetings with financial advisors and their clients, the European and US debt situations dominate conversation; all are looking for assurance that there will be some form of a solution. In my view, it is almost impossible to square this circle. In simple terms, the chain is as follows:

- Northern Europeans have high personal savings rates and are risk averse.
- They deposit their savings into banks.
- The banks lend out 12.5x their tier 1 capital of 8% (as an example).
- The in-country savings exceed the in-country borrowing.
- In a search for spread, the banks lend the deposits out of country: buy AAA euro-denominated Southern European sovereign debt.

- The so-called AAA borrower has expenses materially in excess of revenues; no functioning tax system and cannot repay the loan.
- The lender has to mark down the value of the asset/loan in order to keep the borrowers whole; equity is written off against the asset impairing the deposits of the savers.
- The borrower is desperate to keep government-driven GDP growth intact and asks the lender for more money.
- The lender has been forced to the brink of insolvency by the prior bad loans; it cannot or will not lend more.
- Governments borrow to backstop the lenders who ultimately fund the additional loans to the bad credit.
- The savers who lost capital due to the original bad loans are now funding the bailouts through taxes rather than savings and none of the structural problems have been solved: southern Europe still has an excess of spending over revenues and a non-functioning tax system.

The result: Standard and Poor's downgraded 11 European countries' debt and the Greek debt restructuring talks broke down on January 13, 2012.

The net effect is a wealth transfer from north to south. The northern populations do not support the wealth transfer while the southern populations refuse to reform spending and tax systems. This cannot be solved short of some form of default and wealth destruction in the Eurozone. Iceland and Ireland lead Europe into the cycle of default and wealth destruction; they are in recovery mode today.

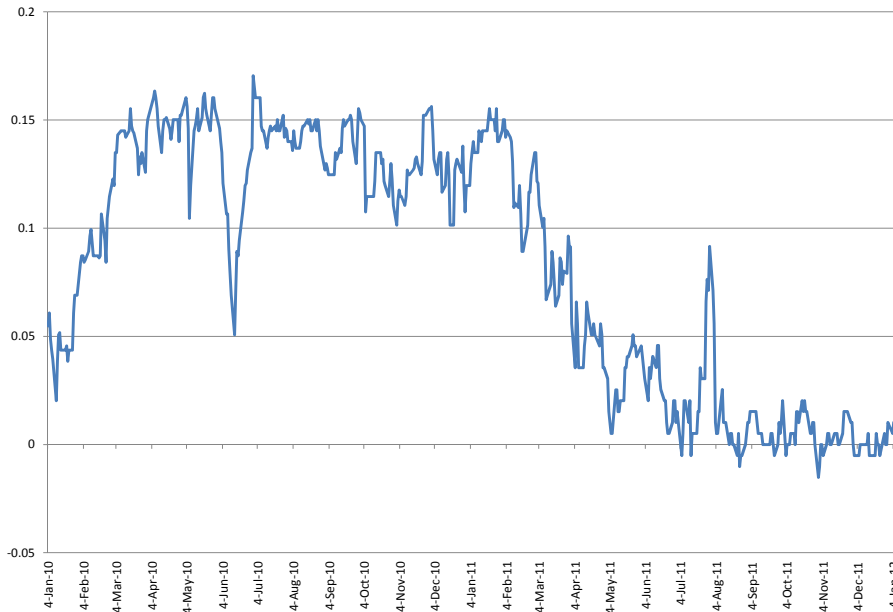
In my view, what is happening in slow motion is the death of the post-war welfare state as populations refuse to fund additional government intervention in the economy and government reaches the limits of its ability to fund current consumption through additional borrowing. Be prepared for a winter of volatility and news-driven angst. Be prepared for a bear market in government debt and structurally higher interest rates in certain markets to compensate for risk. Strangely, this may not be negative for equities. Growth in government may halt, but the private sector is expanding on a global basis.

The key risk over the next six months is that recession in Europe evolves into a global recession. A secondary risk is that a funding crisis in the European banking system spills over into a lending crisis. What can go right for the global economy is that populations and corporations have been saving while governments have been dithering. In the US, they are three years into fixing the personal balance sheet and in Europe, the personal balance sheet is very strong. Corporations are responding to cash building on corporate balance sheets with dividend increases and share buybacks. Capital is forming through individual savings, pension contributions and corporate retained earnings; this capital needs an outlet.

The train wreck in Europe has been in the news constantly since early 2010. It has been the fixation of markets and the media since May 2011 and has driven safe-haven yields (US treasury bills) to levels last seen in the heart of the 2008 crisis (chart 3). There is negative yield on safety.

### CHART 3: Yield decline since May 2011

US Government 3-month T-Bill Index (%)

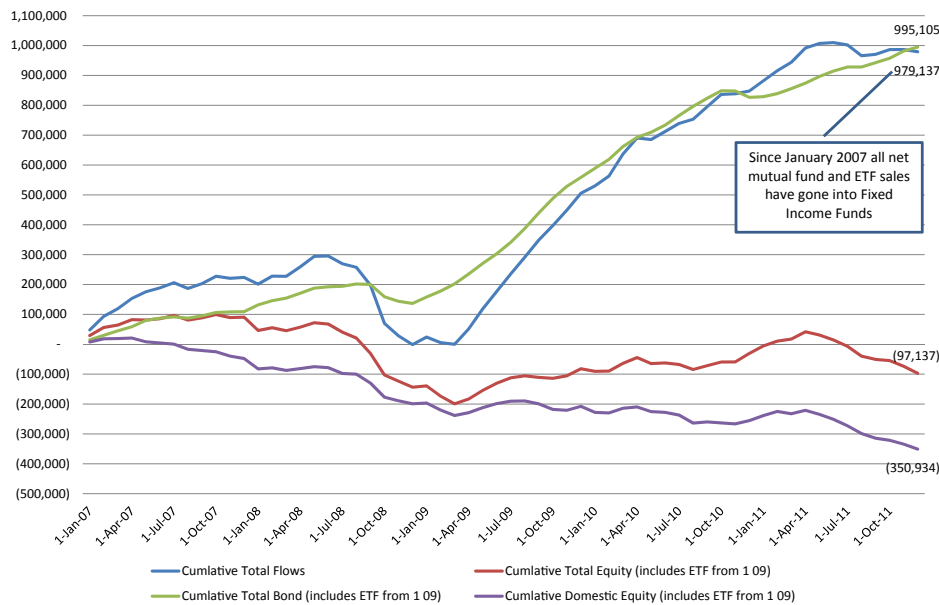


Source: Bloomberg LP, Sentry Investments, as at January 11, 2012

When you look at market behaviour, North American markets had a waterfall decline in early August 2011 driven in part by margin calls. By the ultimate low in early October, markets verged on official “bear market” status. Since then, we have seen continued volatility, but with an upward bias. US retail investors have been net sellers of both domestic and global equities since April. Indeed every net dollar invested has gone into fixed income since January 2007 (chart 4).

### CHART 4: Retail investors moved from equities to yield products

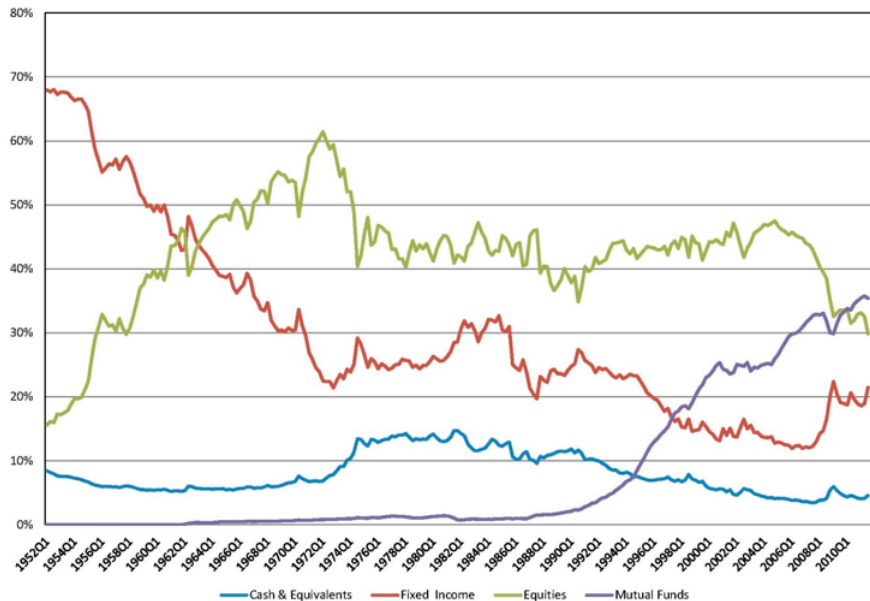
Investment Companies Institute: US Cumulative Fund Flows MF & ETF 2007 to date - US \$975 billion



Source: Investment Companies Institute, Sentry Investments, as at December 31, 2011

The US Private Pension direct equity weight is the lowest since 1956 (chart 5). The positioning is reflective of extreme negative news flow over an extended period of time. The bulk of pension flows today are into defined contribution plans and the majority of defined contribution flows are into fixed-income mutual funds. I think it is safe to say that the equity to fixed income rotation in the pension system has been going on for a very long time.

**CHART 5: Defined benefit and contribution plans have lowest direct equity exposure in 50 years**  
US Private Pension asset mix (September 30, 2011)



Source: Federal Reserve Board Z.1 Statistical Package L.118, Sentry Investments, as at September 30, 2011

Who are the buyers? I do not have the direct data but according to Standard and Poor's:

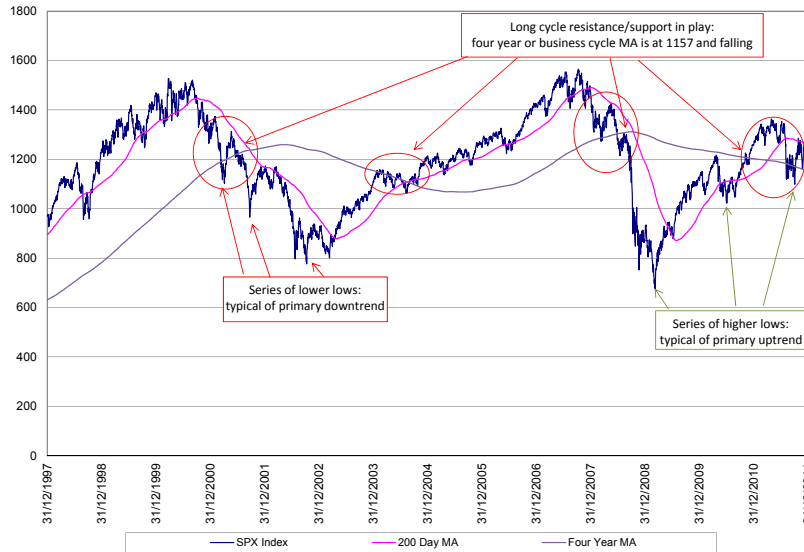
**New York, December 21, 2011** – S&P Indices announced today that preliminary results show that S&P 500 stock buybacks increased 8.4% to \$118.4 billion during the third quarter of 2011, up from the \$109.2 billion registered during the second quarter of 2011 and up 48.8% from the \$79.6 billion posted in the third quarter of 2010.

The inventory of stock for sale is shrinking on two levels: equities held in weak hands in retail and pension funds have been in liquidation for four years and the overall share count (supply available for sale) has been aggressively shrinking as share floats are bought back by corporations. This is not just a North American phenomenon. As valuations have collapsed in Europe and the UK, cash-flush corporations have been actively increasing dividends and share repurchases. It has long been my contention that the type of security that has the greatest scarcity value is the shares of companies with high-quality income and an ability to grow dividends. Share buybacks shrink the supply of these companies and increase the earnings per share.

The crisis is in Europe. Since April, the European equity markets have been a mirror image of the Canadian market: winter high with a test of the high in April; “official” trend change (50-day moving average (MA) crosses 200-day MA in a Death Cross) in July. Attempts to rally are contained around the flat-lining 50-day MA while respecting classic resistance around the 200-day MA. Strangely, the US market continues to lead in a potential recovery: it was the best-performing major market in 2011.

The average value for the S&P 500 over the past four years is 1,157: in rallies, longer-term holders tend to sell when they are “whole.” In corrections, selling tends to dry up when the holder is under water. The four-year MA acted as support and resistance at the 200-day MA has been broken: look for a test of support at the 200-day MA over the next few weeks to confirm a new leg in this cyclical bull market (chart 6).

**CHART 6: S&P 500 moving average over the past four years**



Source: Sentry Investments, Bloomberg LP, as at January 11, 2012

2012 will likely bring a binary outcome. One potential outcome is that the correction of 2011 will resolve into a bear market and test first the November, then October lows and likely undercut these to form what would likely be a final low five to eight months after the initial crisis. Downside risk is likely in the range of 12% to 16% for the broad market: higher for high-beta equities and lower for high-quality ones. The other potential outcome is that the correction has sufficiently compensated for current economic weakness and global growth trumps fear. What is the upside? Forward S&P earnings are running at \$105 with a current run rate of \$95. A little P/E expansion to 15x \$105 gives a target of 1,575 and 20% to 25% upside.

I'd love to say that we can buy zero-volatility, double-digit returns but unfortunately, they do not exist. However, in a world of scarce income with growth, I quite like the risk/reward profile of quality dividend-paying equities today.



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