

TALE OF THE TAPE - US VERSUS JAPAN

Special points of interest:

- Canadian economic growth remain strong and Bank of Canada is watching for signs of inflation.
- In the US, a bigger fear is deflation.
- What happens in US effects Canada. Exports to US account for approximately 37% of Canadian GDP.
- Effects of deflation can be devastating. They include unemployment, bankruptcies, loan defaults, bank failures.
- Many similarities exist between Japan in the 1980s-1990s and the US in the 1990s-2000s.
- There are also many differences which we feel will help to insulate the US from deflation.
- US has acted much quicker to cut interest rates.
- US culture is more accepting of corporate failure.
- US banking system is in better shape than Japan.
- US has benefit of hindsight to study Japan situation.
- Our belief is that it is your client's investment objectives, risk tolerances, and time frames which dictate the best investment strategy, not the current economic or market conditions.

DOES THE US HAVE A DATE WITH DEFLATION?

In Canada, economic growth continues to surprise on the high side, with the Bank of Canada recently issuing a warning concerning future inflation. Indications are that interest rates will be rising in Canada sooner, rather than later.

However, south of the border, fears of deflation continue to dominate the thoughts of policy makers. Deflation could have long reaching and devastating effects on the US economy, and ultimately Canada.

There is little doubt that the US remains Canada's largest trading partner. According to the Economic Research Service of the USDA, 87% of Canada's exports go to the US. This translates to roughly 37% of our GDP being directly effected by what happens in the US. Needless to say, the talk of US deflation is very important to the long term economic health of Canada.

Deflation is a term which has been thrown around quite liberally for the past year or so, but what exactly is deflation? Deflation is defined as a general decline in prices, with emphasis on the word general. Price declines in specific industries which are the result of increasing productivity, or other industry specific factors do not qualify as deflation. However, continuing declines in a broad based measure of pricing, such as

TSX Composite - Q3 02 Performance



S&P 500 - Q3 02 Performance



Source: BigCharts.com

CPI, would qualify as deflation. Essentially, everybody is on a buyers strike. Why buy something today, when you know that in a month or two it will be cheaper?

The effects of deflation on an economy can be devastating, especially in a country like the US, where consumer spending accounts for roughly two thirds of the total economic activity. Imagine the consequences; rising unemployment, massive financial problems, bank-



















ruptcies, loan defaults, bank failures, the list goes on. The spillover to Canada would also be rather devastating.

The causes of deflation are really no great mystery. Essentially deflation is a side effect of a collapse in aggregate demand. Kind of like you would see when a speculative bubble bursts, such as Japan in the 1990's, the US in the 1930's, and most recently in the technology sector. This drop in demand is so severe that producers

DÉJÀ VU ALL OVER AGAIN?

Is History Repeating Itself?

Similarities between Japan in the 1980s - 1990s and the United States in the 1990s - 2000s

	Japan: Stock market bubble
	US: Stock market bubble
	Japan: BOJ popped stock bubble with interest rate hikes
	US: Fed popped stock bubble with interest rate hikes
	Japan: Real Estate bubble
	US: Regional housing bubbles
	Japan: Productivity kept inflation low
	US: Productivity kept inflation low
	Japan: Corporate investment overhang
	US: Corporate investment overhang
	Japan: Business spending shutdown
	US: Business spending shutdown
	Japan: Mounting private sector debt
	US: Mounting private sector debt
	Japan: Credit crunch
	US: Credit troubles, with some credit crunches
	Japan: Pundits saw a rebound
	US: Pundits see a rebound

Source: CNN

must continue to cut prices on an ongoing basis in an effort to find buyers.

The question then becomes: will the after effects of the bursting of the technology bubble translate into widespread deflation in the US economy, similar to what has happened in Japan? Sure, it could happen. However, we feel that while the risk exists, it is rather unlikely.

There are a great deal of similarities between Japan and the US technology sector, but there are also some very significant differences. We feel that it is these differences which will help to keep

the US economy out of a deflationary situation.

First, let's look at the similarities. Japan's bubble was preceded by productivity gains, overspending on capital goods, a heated real estate market, exuberant equity investing, and overeager lending. Even recent corporate scandals in the US were foreshadowed by similar occurrences in Japan. In Japan, it was their "cozy keiretsu" corporate system that encouraged imprudent lending, which resulted in horrific scandal.

The U.S. bubble was exaggerated by huge technology

spending in anticipation of Y2K computer problems and the dot.com explosion. These scenarios resulted in a boom and bust in capital spending and ultimately stock prices.

After the '80s boom, the Nikkei-225 index peaked at nearly 39,000 before falling to a trough of 9,382 in 2001, a 75% loss. In the US, indices have also taken big hits. At its worst level, the tech heavy Nasdaq lost 75%, while the broader based indices lost, but not quite as badly. The S&P sank 45% and the Dow lost 34%.

While these similarities are somewhat eerie, there are also some significant differences. The bubble in Japan while significant in equities, was even more pronounced in real estate. With the exception of some isolated pockets of severe price inflation, the real estate market in the US remains much more balanced. This indicates that the true bubble in the US was in stocks, which are a considerably more liquid asset, than is real estate. The result is that the US economies will be able to re-price the more liquid assets quicker than with the illiquid real estate market. This is according to Josh Byrne, a managing director and portfolio manager with Boston based Putnam Investments, in an interview recently published in a December 11, 2002 Globe and Mail column.

There are also other differences which should allow the US economy to withstand slipping into deflation. In Japan, the Bank of Japan cut interest rates. However, the pace with which rates were cut was somewhat slow. For example, in the US, the overnight rate hit 1.75% within 20 months of the equity peak. In Japan, it took nearly 6 years to reach that level.

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Yes, the Japanese rates were coming from a higher level. With the benefit of hindsight, it becomes clear that much more aggressive action was needed to ward off deflation.

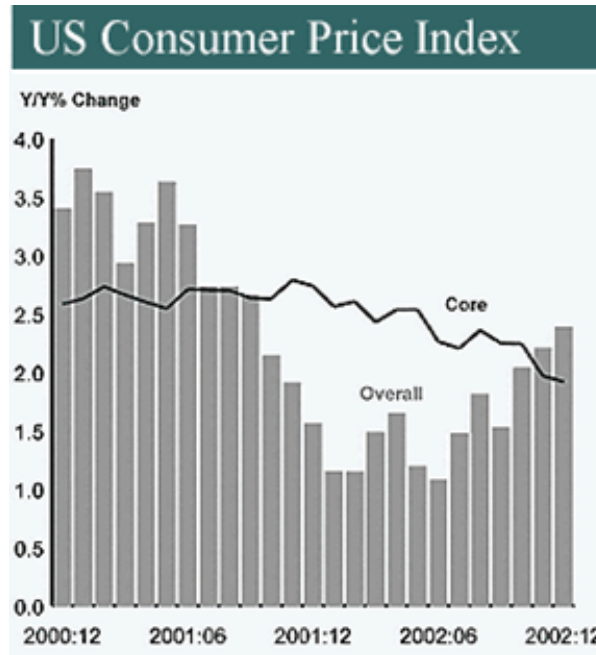
In Japan, the culture is much different than in the US. In Japan, it is not culturally accepted for a company to fail. As a result, many Japanese companies were allowed to stay in business much longer than they should have been. This caused an inefficient use of capital, as funds were used to prop up businesses that were failing, rather than having that capital re-deployed.

In the US, those companies which were failing were allowed to fail. That means that those companies' assets have been sold, and their workers and assets were deployed to industries and companies with better prospects.

We are starting to see some evidence of structural changes in the Japanese economy. Banks are starting to get serious about their non performing loans, and there are other corrective measures being implemented. It appears to be too little too late, as evidenced by the decade long deflationary environment.

Another difference has to do with the fiscal policies of the governments. In Japan, the government continued to raise taxes, essentially taking money out of the pockets of consumers. In contrast, the US has cut taxes, helping to free up cash for the consumer to spend.

The US has also had the benefit of time and hindsight. This has allowed them the opportunity to study the Japan situation; what caused it, policy makers' reactions, and the results of those actions. This should help to keep the US policy makers focused on how to best deal



Source: BMO Economics

with any potential deflationary threat.

Given this, accounting and financial reforms should be implemented much more quickly in the US than was the case in Japan. Critically, labor-market flexibility, expansive fiscal policy, and tax cuts all bode well for a relatively more benign fallout from the U.S. bubble.

Thus far, the US has managed to avoid deflation. We have seen an increase of year over year inflation in December of 2.4%. When we look at the core inflation rate, which excludes the volatile food and energy components, it slipped to 1.9% from November's 2.0%. Much of this can be attributed to year end discounting by the car companies, clothing stores, and household furnishings.

Helping to offset price declines in the goods sectors, we are seeing pricing increases in the services sector, where healthcare prices, education, and recreation are all rising.

Looking forward, it appears as though continued high energy prices will take a bite out of consumer spending. That should help to keep the core rate of inflation near current, subdued levels. Given the increasing prices in the services sector, we don't foresee a significant risk of widespread deflation.

Given this uncertain future, what is the best investment strategy?

Our belief is that it is not the current market or economic environment which dictates the best investment strategy for your clients. Rather, we believe that it is your client and your client's particular circumstances which dictate the best investment strategy. That means that the best investment for your clients, is a well diversified portfolio, custom built to meet their investment goals and objectives .

If you would like more information on how **Paterson & Associates** can assist you in developing a customized portfolio solution for your clients, please contact us.

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TOP RANKED FUNDS
(DECEMBER 2002)

1	Talvest Global Health Care	Healthcare
2	Sprott Canadian Equity	Canadian Equity
3	Bissett Microcap	Canadian Equity
4	Fidelity Canadian Disciplined Equity	Canadian Equity
5	Trimark Global Balanced	Global Balanced
6	Elliott & Page Monthly High Income	Income
7	Universal Precious Metals	Canadian Resource
8	CI Signature Select Canadian	Canadian Equity
9	Royal Precious Metals	Canadian Resource
10	Cundill Canadian Security	Canadian Equity

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