

Towards a New Global Financial Architecture

We are pleased to provide the latest edition of *inFocus*, the semi-annual newsletter from our private wealth management team.

This edition's highlights are:

Towards a New Global Financial Architecture

Surinder Suri, President
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Managing Your Property Interests While Away

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Where Do We Go From Here?

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We would like to thank all of our authors for their contribution to this edition of *inFocus*.

Domestic economic issues will test President-Elect Obama's leadership. A Democratic Congress needs to move forward with fiscal stimulus, a new regulatory regime for financial institutions and an open trading system. President-Elect Obama must move ahead with the cooperation of other world leaders to formulate a new global financial architecture.

Transitions are difficult, economic history attests to that. Bretton Woods, over sixty years ago, ushered in a new economic era. The global economic and financial landscape is markedly different now and a new international economic order is required. The logic of the current global political and economic diversity and the dynamics of the economies of China, India, Brazil, Russia, the Middle East and others warrant a fresh partnership with the United States, the European Union, Japan and other developed economies. The current synchronized credit and economic turmoil increases the urgency for a coordinated global strategy. The centrepiece of that is financial institution stability, reforms and safeguards for the future. The first decade of the twenty-first century has experienced significant political and economic stress; the latter induced by enormous liquidity and historically low nominal interest rates facilitating highly leveraged financial instruments concealing the intrinsic value of assets. The enlarged Washington forum will address the immediate economic issues. The broader mandate is to inaugurate a challenging era of economic cooperation for the next generation.

Credit Crunch - Origins and Dimensions

The 2007-08 credit crisis emanated from the mispricing of risk on financial products linked with the subprime U.S. mortgage

market. The off-balance sheet securitized products introduced by commercial and investment banks grew rapidly in the U.S. and in Europe over the past two decades. The complexity and ingenuity of these products skirted the capital control requirements of the issuing entities. Excessive leveraging put into question the viability of these financial institutions. Substantial losses on these products and the ensuing liquidity crunch paralyzed capital markets. Several major financial institutions in the U.S. and in Europe were unable to sustain these losses. The Federal Reserve, the Bank of England, the ECB and other central banks provided liquidity to these institutions and to capital markets. The U.S. Administration has also assumed responsibility for the troubled liabilities of Fannie Mae and Freddie Mac. The Treasury's Troubled Asset Relief Program (TARP) and the comprehensive Emergency Economic Stabilization Act 2008 approved by Congress provided \$ 700 billion to the U.S. government to help address problems with illiquid mortgage securities and other distressed assets. The recapitalization of the banks especially in the U.S. and in Europe is a recognized priority. The proper functioning of interbank borrowing and the lowering of the Libor rate are essential to secure stability. The Treasury has allocated \$250 billion to restore bank capital. The Federal Deposit Insurance Corporation will guarantee the debt of all insured institutions. The Fed and the Treasury have also activated resources for money market funds and for the commercial paper market. A €1.9 trillion fund has been initiated by European governments to assist their financial institutions.

The Fed has become a key anchor in the current financial crisis and its powers will need to be broadened in a new regulatory regime. Likewise the other central banks have

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Managing Your Property Interests When Away

By **Kurt R. Pearson**, *Partner*
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The next time you head down to Florida for a break from Canada's harsh winters or depart for Europe on a prolonged business trip, you may want to consider the benefits of a limited power of attorney to ensure your property interests are managed effectively in your absence.

A standard general power of attorney for property allows you to select someone to deal with your real estate and other financial affairs. However, a general power may give pause to some individuals simply because it is so broad: Unless restrictions or conditions are inserted into the power of attorney, the donor is authorizing the attorney to undertake a very wide array of legal acts on the donor's behalf. The general power can be exercised during a period of incapacity of the donor, if such a clause is contained in the power of attorney.

An alternative is a limited power of attorney for property. Don't be deceived by the name though – a limited power of attorney has a variety of uses and benefits.

A limited power of attorney allows you to authorize a party to act on your behalf with respect to your property interests in circumstances you set out. If you are out of the province or country while trying to sell your home and Offers to Purchase are expected, a limited power of attorney will allow, for instance, your solicitor, your spouse or a trusted friend to act for you in your absence. In addition to completing real estate transactions, a limited power of attorney is also commonly used to negotiate securities transactions, have bills paid and draft cheques.

Properly drafted limited powers of attorney can alleviate a lot of problems when your presence is not possible to effect a transaction. Unlike some traditional general powers of attorney, the limited version allows you to control the scope of the powers and the timeline of its effectiveness.

It is important, though, to remember the restrictions of a limited power of attorney. The power of attorney becomes void upon completion of the particular transaction for which the limited power has been given or at its scheduled termination. It is important to have arrangements made in preparations for these considerations. The specialized power of attorney can and should be drafted such that it does not revoke the donor's grant of a general power of attorney. A proper will should also be in place as well as the appropriate general powers of attorney for property and personal care.

A limited power of attorney is a powerful tool and care should be taken to ensure its proper drafting. It is therefore important to obtain legal advice when preparing a limited use power of attorney. Improperly drafted, it may grant the attorney powers that are too great or not appropriate for the circumstances.

Other issues may also arise where a donor may benefit from legal advice. For instance, in an effort to prevent fraudulent property conveyances, when granting a limited power of attorney to deal with real estate transactions donors are now required to record the document at a land registry office. Without proper registration, a real estate transaction relying on the power of attorney may be deemed invalid – a costly but easily avoidable headache.

So, before you board that next plane, consider the benefits and peace of mind a limited power of attorney will provide you on your journey.

This information provided in this article is meant to be general in nature and is provided for legal information purposes only. Before preparing a power of attorney you should seek legal advice to ensure that it is appropriate to your particular circumstances.

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Where Do We Go From Here?

By D. Christopher King, *Assistant Vice-President*
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The capital markets have been unkind over the past year, to say the least. During the summer, markets were pricing in a typical growth slowdown with additional pressure from high energy costs. Then the credit crunch pummelled both Main Street and Bay Street, and cast uncertainty about economic recovery.

What is our investment strategy now?

As dire as the outlook may be, down markets are to be expected and are part of the economic cycle. Our investment analysis orients us to high quality companies, with strong balance sheets, led by strong and capable management. These criteria result in solid long-term performance with less portfolio fluctuation. Despite the market direction, the companies we admire find opportunities that may be unforeseen to investors. Along the way, they generally pay rising dividends which can comprise a significant component of long-term returns. A review of the Bank of Nova Scotia stock price is illustrative, but any of the Canadian banks would be similar. In 1987 after “Black Monday”, the stock was priced at \$2.80 adjusted for splits. After the Asian crisis of 1998, after it had fallen 25%, it was at \$12.50. Currently the stock is in the \$30’s, thus the pattern of wealth creation is obvious. Good companies find ways to grow through reinvesting shareholder capital. Note that the current dividend yield on that stock purchased 20 years ago is now 70%. While volatility is unsettling, good companies prosper regardless of conditions.

For perspective, at the beginning of the fourth quarter, the valuations of both the U.S. and Canadian equity markets are among the lowest in decades. Even with a deeper economic slowdown, market valuations are in the bottom quartile of historical averages, thus discounting an impending depression. Our analysis indicates a depression is highly unlikely given the focussed attention of governments worldwide. While a deleveraging process as a result of a credit bubble continues, the major economies of the developed world will, over time, restore national and household balance sheets, while developing economies will continue to grow. Leveraged hedge funds and small investors through mutual fund redemptions have provided the panic selling that has driven the broader markets into these attractive valuations. We think the liquidations are slowing, and now a period of convalescence or base building is required before recovery. This repair takes time, but the markets look ahead, and will start to rise long in advance of an economic recovery. In many cases, the capital markets begin rising even before the worst of the recession is upon us. With significant cash on the sidelines, these

weak capital markets may stage a rebound sooner than many think.

While most investors focus on stocks, bonds have also been affected in this cycle. The failure of Lehman and AIG disrupted money market funds and cast doubt on a banking system that is built on confidence and trust. As a result, any firm requiring debt financing was subject to extreme discounting by the capital markets, as buyers sat on the sidelines. This dislocation has led to some firms having their debt priced to unprecedented levels despite the apparent long-term stability of the firms. As an example, Pepsi, a well run international firm with steady growth, offered a debt issue at 450 basis points over U.S. Treasuries, compared to 150 normally. This spread level indicates just how difficult the credit markets have become, even for top level firms. While our bond holdings have been marked lower as most debt instruments have, we expect that they will improve rapidly as liquidity and confidence return to the system. Already we are seeing evidence of positive price movements in the fixed income markets.

So what to do?

It is in these challenging markets that the Morgan Meighen investment style bears results for our clients. While many revered investment managers have been devastated and high profile hedge funds have been liquidated, we have been rewarded by adhering to our conservative, proven investment process. Our private client portfolios generally outperform the broader markets in adversity, and we look to take advantage of weakness to increase or initiate favoured positions where possible. The volatility and media headlines unsettle us all, but brighter days will be ahead. The old expression “This time it’s different” has never been correct, and will not be this time either. Do not fall under the sway of the media, and remain confident in the securities you hold. Bear markets are generally shorter than bull markets, and the recoveries lift markets to higher levels than previous. Rest assured, better days will be ahead.

Warren Buffet wrote an Op-Ed piece in The New York Times on October 16, 2008 expressing similar sentiments. “Let me be clear on one point: I can’t predict the short term movements of the stock market. I haven’t the faintest idea as to whether stocks will be higher or lower a month – or a year – from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.”

We at Morgan Meighen & Associates concur with Mr. Buffet, one of the most highly regarded investors of our times.

new responsibilities thrust upon them. Government involvement and scrutiny in market-based financial institutions is likely to stay. The IMF not only has an important role in assisting developing countries and others, it now must coordinate a comprehensive economic policy initiative with the G7 and the emerging economies especially China, India, the Middle East, Russia, Brazil and Africa.

Is the Business Cycle Alive?

After a robust six year business cycle the global economy is set to grow by about 2.5% in 2008 and in 2009. Excesses lead to downturns and this one is exceptional because of credit constraints. Curtailment of domestic demand characterizes this cyclical contraction. Central banks have turned their attention to lowering interest rates and this trend is likely to continue for some time. The Fed, the ECB, Bank of Japan, Bank of Canada and the central banks in China, India and in other countries have decreased short-term rates and eased access to credit. Fiscal policy will also provide stimulus in the form of tax relief and outlays on infrastructure and other programs. Deleveraging on the part of companies, households and other institutions will be painstaking and prolonged. Nevertheless the business cycle is alive and recovery is anticipated in 2010. Deflation is unlikely but inflationary pressures induced by high oil and commodity prices will recede. Wage inflation is not in the cards. However major industry structural issues need to be resolved in several sectors, notably autos and financials. An open global trading system should not be compromised in the current environment.

Emerging markets

Emerging markets are anticipated to experience 5% growth next year. China's growth rate is estimated at 8.0% and India will likely advance by 7.0% in 2009. Growth in these two economies is fostered by domestic demand. Restricted capital inflows from the OECD countries to the emerging economies contribute to the slower pace of economic activity relative to their robust performance in the last three years. Higher growth rates are anticipated in emerging economies after the interlude of 2008-09 as infrastructure spending resumes. Moreover intra-Asian trade has increased considerably in recent years.

Growth in the Middle East is fed by economic reforms, the accumulation of wealth and infrastructure outlays.

Canadian Economic Framework

The minority Harper Conservative government faces the prospect of fiscal deficits stemming from economic contraction. Declining oil and commodity prices are reflected in dollar weakness. Equalization payments to the provinces (including Ontario), the demand for infrastructure spending and social services constitute a challenge for Finance Minister Flaherty. Canada's fiscal framework is constructive with the debt-to-GDP ratio at 26%. Growth in 2009 is estimated at 1%. The Canadian government is to purchase \$25 billion of insured mortgages. Policy measures for credit markets, deposit insurance, pension funds, financial institutions and the auto sector are anticipated in the November economic statement. A coordinated federal-provincial response to the downturn is forthcoming. The Bank of Canada has provided significant liquidity and is likely to lower interest rates.

Going Forward

Strengthening the global macroeconomic framework entails:

- A revitalized prudential regulatory system with a focus on risk assessment and transparency of financial products
- A rigorous financial reporting system
- Broadening the powers of central banks and regulatory institutions
- Consistency and cooperation on macro and micro economic policies among the OECD and emerging economies
- Investment in infrastructure and resource development

Leadership from the White House and the new administration is an essential requisite to secure a new financial architecture.

By **Surinder K. Suri**, *President*
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