

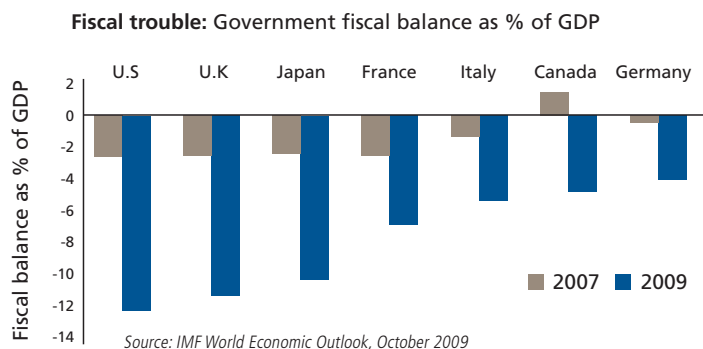
What do rising government debt-loads mean for investors?

The Great Recession of 2008–09 has ended. Employment trends are firming and the probability of a double-dip back into negative growth has mostly ebbed away. However, the clean-up from the recession is still very much underway. The next big challenge will be shrinking the mountain of IOUs governments have piled up in their efforts to fight the financial crisis. Today's elevated debt levels, exacerbated by trends in population aging, may be a challenge almost as crippling as the recession itself. In Europe, debt problems have plagued Greece, Spain and Portugal recently, with all three running deep budget deficits.

But is this situation uncommon? The gap between government revenues and expenditures is large, but surely it's not all that surprising given the size and nature of the recent downturn. In the past, governments have often cycled into and – admittedly less often – out of deficits without causing permanent damage to an economy's ability to innovate and grow. Unfortunately, this situation is unique. Today's deficits are unusually large and pervasive, debt burdens have increased significantly, and the outlook for paying down debt is poor given the impact of aging populations on both revenues and expenditures.

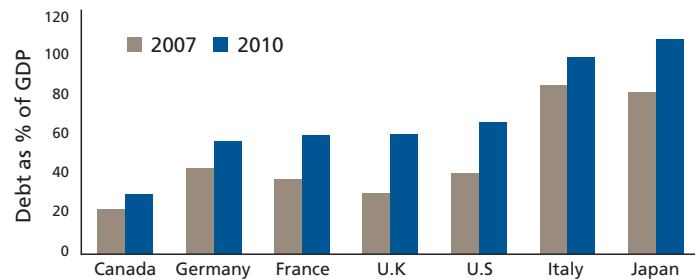
Entering a new era

The following graph highlights the sharp acceleration in government deficits as a result of the credit crisis. In the U.S., the deficit is unprecedented whether viewed in dollar terms (\$1.4 trillion) or in relation to the size of its economy (12.5% of GDP). Other countries are in a similar position – both the UK and Japan face shortfalls in excess of 10% of their GDP while the remainder of the G7 nations has also seen a sharp deterioration. Outside of the G7 nations, several countries have recently hit the financing wall – the list includes Dubai, Ireland and Greece, with more likely to come.



These large deficits have wreaked havoc on government debt levels. The graph below illustrates the increase in government debt levels as a percentage of GDP between 2007 and 2010. In several cases, the starting point was already troubling. In 2007, net debt in Japan and Italy already accounted for approximately 80% of total annual economic output.

The wall of debt keeps getting higher: Government debt as % of GDP



Source: OECD, June 2009 Outlook, BMO Nesbitt Burns

Moving the calendar ahead to 2010, debt ratios have ballooned. Japan's debt-to-GDP ratio has climbed to 109%, now exceeding the annual output of its economy. Italy's ratio has also increased to over 100% of its GDP. However, the more shocking increases come from the U.S. and the UK. As a result of the myriad bailouts undertaken to alleviate the financial crisis alongside a collapse in tax revenues, the net debt-to-GDP ratio of the United States has jumped 26% to 68% of GDP; in other words, the United States has a debt of around \$10 trillion dollars! In the UK, the rate of deterioration has been worse, with debt rising nearly one-third between 2007 and 2010 to 62% of GDP. France and Germany are in similar territory. Canada's 9% debt-to-GDP ratio increase to 31% of GDP is more modest, but not by much.

Why should we care about government debt?

Japan's debt-to-GDP ratio topped 100% in 2000 and hasn't looked back since. Yet Japan remains a functioning society. Why not simply ignore the debt? After all, it's not as if the loans ever come due all at once while, in theory, nations live forever.

There are several risks associated with escalating government debt. It should be clarified that Japan is a special case because more than 90% of the country's national debt is owed to its own citizens. By contrast, most other countries have financed large portions of their debt via bond sales to foreign buyers, thereby exposing themselves to fluctuations in global capital markets.

Risks associated with high government debt loads

- **Higher interest rates and borrowing costs.** The main risk of prohibitive government debt is that of higher interest rates and, hence, slower economic growth. Large-scale government borrowing soaks up a large quantity of available investment funds, reducing the finite supply of national savings. For any given demand for funds, a lower supply drives up the price – the real interest rate. There are other considerations. Investors may perceive rollover risk of government debt and other threats to debt sustainability, and demand higher interest rates in compensation. This may be exacerbated by an increase in global bond supply, as many countries face higher

continued on back page

CUMIS Market-based Funds

Gross Annualized Rates of Return as at December 31, 2009

FUND	3 Month (%)	1 Year (%)	3 Year (%)	5 Year (%)	10 Year (%)
Money Market					
Canadian Money Market Fund (PH&N)	0.1	1.0	3.1	3.2	3.4
Fixed Income					
Retirement Security Fund (CUMIS)	1.1	4.3	4.6	4.8	5.5
Universe Bond Index Fund (BLK)	-0.1	5.5	5.0	5.1	6.7
Income Fund (Ethical)	-0.1	7.7	5.6	5.9	—
Fixed Income Fund (McLean Budden)	-0.4	6.1	5.2	5.2	6.9
Short-Term Bond & Mtgage Fund (PH&N)	0.8	8.1	5.7	4.9	5.9
Bond Fund (PH&N)	0.2	10.2	5.7	5.7	7.2
Balanced					
Balanced Fund (Ethical)	1.8	15.9	0.6	5.4	—
Balanced Core Fund (McLean Budden)	2.1	16.7	0.5	4.9	5.9
Balanced Fund (Mawer)	2.3	17.6	1.2	5.9	7.1
Balanced Fund (PH&N)	1.8	20.4	-0.1	4.3	4.6
Canadian Equity					
S&P/TSX Composite Index Fund (BLK)	3.8	35.2	0.1	7.9	5.7
Canadian Equity Fund (Bissett)	3.6	42.2	-0.9	6.8	—
Growth Fund (Ethical)	3.7	25.3	-2.7	5.9	—
Special Equity Fund (Ethical)	9.3	33.3	1.0	8.0	—
Canadian Small Cap Fund (Franklin Templeton)	14.8	77.3	-8.3	4.5	—
Large Cap Canadian Equity Fund (Mawer)	4.6	30.9	1.8	8.2	10.7
Small Cap Canadian Equity Fund (Mawer)	11.1	53.0	4.5	9.8	17.1
Canadian Equity Core Fund (McLean Budden)	4.3	35.7	0.1	7.5	9.3
Canadian Equity Value Fund (McLean Budden)	4.5	29.3	0.6	6.9	10.7
Pure Canadian Equity Fund (PH&N)	3.4	36.2	-1.7	5.9	7.8
Canadian Equity Fund (PH&N)	3.5	35.2	-4.4	3.4	4.6
Dividend					
Dividend Income Fund (PH&N)	3.2	34.4	-3.8	3.8	10.6
U.S. Equity					
U.S. Equity Index Fund (BLK)	3.5	7.0	-9.2	-2.5	-4.4
U.S. Equity Fund (Mawer)	2.6	3.8	-5.7	-0.9	-0.5
American Equity Fund (McLean Budden)	3.7	11.2	-6.1	-0.5	—
U.S. Equity Fund (PH&N)	3.1	5.8	-9.3	-3.8	-5.5
Foreign Equity					
EAFE Equity Index Fund (BLK)	-0.2	12.0	-9.1	0.9	-2.0
International Fund (Bissett)	0.7	15.9	-9.1	1.1	—
International Equity Fund (Ethical)	2.5	19.4	-8.1	1.1	—
Non North American Equity Fund (Mawer)	1.9	26.5	-4.7	5.9	3.0
Global Equity Fund (McLean Budden)	2.9	13.4	-6.5	0.7	-0.8
Overseas Equity Fund (PH&N)	-0.1	26.6	-7.1	1.8	—
Growth Fund (Franklin Templeton)	2.0	13.9	-8.0	0.7	—
Actively Managed Asset Allocation Funds					
LifePoints® Balanced Income (Frank Russell)	1.6	14.0	2.4	5.2	—
LifePoints® Balanced Growth (Frank Russell)	2.8	17.7	-0.5	4.8	—
LifePoints® Long-Term Growth (Frank Russell)	3.6	20.4	-3.1	4.5	—
LifePoints® All-Equity (Frank Russell)	4.3	22.0	-5.9	2.7	—
Index Managed Asset Allocation Funds					
Conservative Balanced Index Fund (BLK)	1.9	12.9	1.2	4.2	4.0
Moderate Balanced Index Fund (BLK)	2.2	16.2	-0.4	4.5	4.0
Aggressive Balanced Index Fund (BLK)	2.6	19.4	-2.0	4.6	3.6
Target-date Funds					
LifePlan™ Retiree Fund (McLean Budden)	1.0	11.7	2.1	4.7	5.8
LifePlan™ Retirement 2010 (McLean Budden)	1.0	11.8	1.6	4.9	5.6
LifePlan™ Retirement 2015 (McLean Budden)	1.5	13.8	0.9	4.7	5.5
LifePlan™ Retirement 2020 (McLean Budden)	1.7	14.9	0.3	4.6	5.3
LifePlan™ Retirement 2025 (McLean Budden)	1.9	16.1	-0.2	4.6	5.2
LifePlan™ Retirement 2030 (McLean Budden)	2.2	17.3	-0.6	4.5	5.1
LifePlan™ Retirement 2035 (McLean Budden)	2.4	18.3	-1.2	4.4	4.9
LifePlan™ Retirement 2040 (McLean Budden)	2.6	19.4	-1.8	4.3	4.7

Note: All performance data is shown on a gross or "pre-fee" basis except for Retirement Security Fund

1 - Retirement Security Fund charges 1.2% in Investment Management Fees. The returns shown above for RSF are net of fees.

2 - Please see the Fund Fact Sheets posted on the CUMIS website (www.cumis.com) for benchmark returns on all fund(s).

3 - Pooled funds are not guaranteed, their values change frequently and past performance may not be repeated.

News from the Government

Government Retirement Programs 2010

Old Age Security – First Quarter of 2010

Basic Benefits	GIS max. Single	GIS max. Married	Spouse's Allowance	Widow/Widower
\$516.96	\$652.51	\$430.90	\$947.86	\$1,050.68

	Canadian Pension Plan		Quebec Pension Plan	
	2010	2009	2010	2009
YMPE	\$47,200.00	\$46,300.00	\$47,200.00	\$46,300.00
Basic Exemption	\$3,500.00	\$3,500.00	\$3,500.00	\$3,500.00
Contribution Rate				
▪ employee	4.95%	4.95%	4.95%	4.95%
▪ employer	4.95%	4.95%	4.95%	4.95%
▪ self-employed	9.90%	9.90%	9.90%	9.90%
Annual contribution (maximum)				
▪ employee	\$2,163.15	\$2,118.60	\$2,163.15	\$2,118.60
▪ employer	\$2,163.15	\$2,118.60	\$2,163.15	\$2,118.60
▪ self-employed	\$4,326.30	\$4,237.20	\$4,326.30	\$4,237.20
Retirement benefit (maximum, per month)	\$934.17	\$908.75	\$934.17	\$908.75
Death benefits				
▪ lump sum	\$2,500.00	\$2,500.00	\$2,500.00	\$2,500.00
▪ spouse maximum (per month) <i>under 65</i>	\$516.57	\$506.38	\$776.41	\$765.18
▪ spouse maximum over 65 (per month)	\$560.50	\$545.25	\$560.50	\$545.25
▪ orphan (per child per month)	\$214.85	\$213.99	\$68.22	\$67.95
Disability benefits				
▪ contributor (maximum, per month)	\$1,126.76	\$1,105.99	\$1,126.73	\$1,105.96
▪ child (per child, per month)	\$214.85	\$213.99	\$68.22	\$67.95

Why should we care about government debt?...con'd

borrowing needs. Finally, nominal yields on sovereign securities may also rise due to higher inflation expectations given the delayed impact of higher government spending. All told, national borrowing costs would be expected to rise.

- **Slower growth and weaker tax revenues.** High interest rates can dampen growth and reduce tax revenues. They can also push up interest payments on the debt, making the debt at once harder to service and harder to escape. In order to bring down the deficit, governments typically cut spending and raise taxes. In either of these scenarios, businesses and households are made poorer on a relative basis. To the extent that this occurs in the U.S. – given its size – we can expect to see lower world output as well.
- **Limited policy choices.** The need to divert revenues to pay interest on debt reduces the set of policy choices available to governments. To keep interest rates from spiraling upward, countries end up giving up fiscal flexibility to capital markets (the dreaded “bond vigilantes”). Emerging economies have seen this story play out many times. New, valid spending needs may go unmet. A large debt curtails the flexibility of a nation to respond to the next recession or other shocks, ultimately making it worse off.
- **Intergenerational impact.** Finally, there is the issue of intergenerational equity that is raised when debt from one era remains a burden for future generations. In the past, when the debt burden has shifted to future generations of workers there were proportionally more of them, so each person’s individual share of the burden was small. Conversely, in the current situation, the labour force is expected to grow more slowly, or even shrink. Thus, any debt carrying over to future generations becomes harder to repay.

The yoke of demographics

Long-anticipated demographic shifts are quickly becoming a reality. The peak of Canada’s baby boom is aged 51, while “the leading edge” (comprising those born in 1947) has already reached retirement age. U.S. trends are similar, while in some countries, such as Japan and other Western European nations, aging trends are more advanced and acute. Given the looming demographic challenges across the developed world, the timing of the bailouts and stimulus could scarcely have been worse.

Aging reduces the working-age share of the population and produces a shift toward groups with lower labour-force participation, i.e., part-time employees. Both trends mean fewer hours worked in society, often for lower pay. Lower labour force participation ultimately means a lower economic growth rate, unless productivity growth ramps up at the same time. While not ruling out this scenario, recent trends in productivity have been mixed – productivity tends to be stronger in the U.S., but weaker in Canada and elsewhere.

For any given rate of productivity growth, lower hours worked means lower per capita nominal output and lower government income tax revenues. This is the first component of the looming fiscal squeeze. The second component comes from rising age-related expenditures. Simply put, an aging population costs the government more, mainly in the form of health care expenses. Typically, the bulk of the draw on

the health care system comes in the latter years of a person’s life. In addition, age-related benefits, such as Old Age Security, commence. The net effect for governments is that as a society ages, costs go up while revenue growth declines.

What can be done?

There are really only three choices available to governments to manage current debt levels: default, inflate or fix.

- **Default:** While defaulting on loans is a possibility for some governments, it’s a highly unlikely one. This is particularly true for the U.S., which can, as a last resort, print money to make interest payments and let the chips fall where they may. Default is typically the realm of developing nations already facing penurious borrowing costs, a collapsing currency and for which repayment is a practical impossibility. Moreover, renegeing on debts owed to foreign creditors has been, at times, a winning political strategy. For the U.S. and other developed nations, the mere threat of default is a powerful motivator that should force hard choices to be made today.
- **Inflate:** By tolerating higher inflation, a country can reduce the real value of its debt. Aside from the fact that central bank credibility rests on this event not occurring, it can’t be a solution if inflation rises across the developed world. Untethered inflation would ensure that interest rates (and hence nominal debt service costs) escalate rapidly, offsetting the intended effects of higher inflation. In fact, the inflation rates required to overcome the impacts of higher interest rates are unrealistically high, so inflation alone cannot stabilize the debt-to-GDP ratio. Furthermore, health care inflation typically rises about twice as fast as general inflation, suggesting faster general inflation would make any health care funding shortfall worse.
- **Fix:** Righting the fiscal imbalance is clearly the only real option, but this option must go beyond making token changes and hoping that higher growth and productivity solve the problem. Like inflating the economy, it’s an issue of scale: the required rate of economic growth to catch up to accelerating spending approaches double-digits. For countries with large future challenges, the only answer lies in higher taxes and/or reduced entitlements. This necessarily involves politicians making hard choices such as abandoning pledges not to raise taxes or shifting the tax emphasis toward more efficient consumption taxes like the GST. It also involves a new bargain with citizens regarding what services they can expect from the government in retirement.

The list of countries that have faced fiscal crises in the past is long (and includes Canada). Fortunately, provided hard decisions are made, time and economics are on our side. If the imbalance is attacked early enough, less will need to be done. Where there is a need for productivity gains, such as in the field of health care, these gains can be achieved if the right incentives are provided.

At the very least, the next decade promises to be a golden age for innovative public policy. The world’s advanced economies face a decade of cuts to services, higher taxes, and other battles to slow the growth rate of entitlement spending. We hope governments will send clear signals that they intend to make the necessary adjustments. We expect this to be a key theme for 2010, with the risk of increased financial market volatility if these challenges remain unaddressed.

This article is reproduced with the permission of Phillips Hager and North Investment Management Limited.