Investment Commentary

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As Clear as Mud

Global economic indicators appear to point to a slower period of growth ahead. Recent comments from Federal Reserve Chairman Ben Bernanke also tend to confirm a slowdown in the U.S. "We don't have a precise read on why this slow pace of growth is persisting......maybe some of the headwinds that have been concerning us like weakness in the financial sector, problems in the housing sector, balance sheet and deleveraging issues, some of these headwinds may be stronger and more persistent than we had thought".

Conversely, a majority of private economists believe economic growth will expand in the second half of the year now that high oil prices and manufacturing bottlenecks out of Japan are beginning to ease.

Corporate profits are strong, the U.S. economy is starting to create jobs, unemployment insurance claims are dropping, and the rise in the stock market over the past two years has added to households' net worth and helped to improve consumer confidence.

These contradictions make the economic outlook as clear as mud. Still, with a fairly healthy corporate sector and interest rates at historical lows, *we do not see a near term correction in the stock market of any significant or lasting magnitude. The current minor, albeit worrisome pullback, appears contained.*

Typical Business Cycle

By the standards of post-war history, the current business cycle is not yet complete. While many good arguments have been made that this business

cycle "feels different", the typical cycle lasts 4 to 5 years. There is not the excessive speculation one normally sees at the top of a business cycle, interest rates are still very low and commodity prices have eased but remain firm. We are therefore likely experiencing a typical mid-cycle slowdown.

A Tipping Point in Greece

Protests in Greece against government austerity measures are a sober reminder to all politicians that an angry citizenry can quickly turn to violence. Protests in the Middle East and North Africa are widely seen as protests against oppressive regimes; however they bear common links to Greece - namely debt and economic inequality. The streets of Spain, Italy, the UK or even the U.S. can also erupt in protest as the issues are fundamentally the same.

In the U.S. the ongoing Congressional debates on the "debt ceiling" are downright laughable. The August 2nd debt limit of $14.3 Trillion is fast approaching and they are bickering over mere Billions. A credible austerity plan is needed yet the politicians are oblivious to the real world outside their windows. Failure to reach an agreement would be catastrophic, yet the political gamesmanship goes on. The attitude is truly surreal.

For politicians in the West, the road best taken is the road that results in less confrontation. For this reason we believe Greece has become a "tipping point" for Central Bankers. They will be required to keep printing. It is the only viable choice to deal with the burden of debt. The issue is not merely an economic one. It is a social and political one.

Investors playing it Safe

With all the uncertainty in the headlines and the memory of the 2008/9 crash still fresh, investors are wary of the stock market. Since late April, nervous investors have redeemed more than $15 billion from U.S. equity mutual funds and channeled nearly $29 billion into bond funds.

What we have witnessed since the 2008/9 crash is a recovery from an extreme credit crunch; a recovery that has needed a massive stimulus in the form of easy money and low interest rates. Going forward it is not clear if the private sector can carry the torch. The normal rebuilding of savings rates and pent-up consumer demand which leads us out of recession is not visible.

The low interest rates offered in the bond market are not nearly enough to satisfy income requirements. Investors, especially those retired and in need of income, are forced to dip into capital. Spending plans are being effected which at the margin is keeping a lid on economic activity.

The Japanese experience was and is similar. Following their stock market and real estate bust in 1990 interest rates have stayed low. Huge public spending works replaced a retrenching private sector. Much like Japan, we are experiencing a “balance sheet recession”, the result of a huge debt buildup over many decades. A huge amount of public debt is now necessary in order to offset the deleveraging from the private and household sectors. Investors are playing it safe with their savings and businesses are less willing to borrow and expand.

Canada’s Day

The Canadian economy has experienced good GDP and employment growth compared to the U.S. and much of Europe. We look for this to continue as long as commodity prices remain firm, even though the market where we sell over 80% of our exports is only limping along.

Over the long term the outlook for commodity prices and thus the outlook for the Canadian stock market is generally positive. In the shorter term a slowdown in China could easily occur. A few more pundits have recently forecast such an event, mainly due to the overbuilding. While not a new issue, it is obviously of major importance for Canada as the Chinese economy is widely seen as the engine of demand for the entire commodity complex.

For now the main global story is centered on the solvency problems in Europe. Indeed, the story for all Western nations is one of repairing lousy balance sheets. In this regard Canada comes out shinning on a relative basis.

Still, governments and their central bankers are in a bind with few options: either they continue to print money (Quantitative Easing), and keep the prices of stocks, bonds and commodities rising; or they stop the monetary easing and let markets normalize. The period ahead may be turbulent but ultimately the money printing option will prevail.

Portfolio Strategy

We are positioned in a moderate way for a recovery in stocks. The majority of our positions remain in the more defensive sectors and in what we regard as well priced companies. Any further pullback in the market would likely cause us to get more aggressive with the mix of securities in the portfolio. Sectors which we would add or increase would primarily be commodity related - Oil & Gas, Gold and Base Metals.

Our bond strategy continues to emphasize the purchase of shorter-term bonds and cash. Extending bond maturities at this juncture promises to be a losing strategy as interest rates are destined to rise over time.

We are comfortable with the overall level of risk in investment portfolios and look to capitalize on the occasional trading opportunities should markets become more volatile.