Investment Commentary

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Fundamentals: Mixed Messages

While economic fundamentals are improving, the message is still very mixed. The consensus forecasts for 2010 call for a rather tepid 2.5 to 3% GDP growth rate, both here and in the U.S. At this modest pace, the private sector is unlikely to commit to large-scale capital expenditures or will have the confidence to hire in a significant way. Companies that are expanding are doing so only marginally. Recent sales trends in the automotive sector are positive. Annual production of 11-12 million vehicles is expected, however this is still well below 18-20 million just 18 months ago.

The growth from new or emerging industries has yet to materialize. Promising sectors such as infrastructure and alternative energy are not large enough and need the support of government to be viable. With governments strapped for cash, sectors reliant on the public purse are unlikely to thrive and be a major source of employment growth anytime soon.

Companies are still in the process of cutting expenses and looking to become more efficient. The U.S. consumer remains deeply indebted. Apart from the financial sector, salaries and wages are not rising. Better than expected retail sales reports suggest the consumer may be turning the corner. "Same store sales", the performance comparison used in the industry, appears encouraging. Yet many retailers have shut down unprofitable and marginal stores while others have gone bankrupt. The statistics are therefore not directly comparable. Overall sales are down. Given the poor employment landscape and a housing market that is still in turmoil (almost one in four outstanding mortgages in negative equity), weak overall retail numbers makes sense. This is not a robust U.S. economic environment. Importantly, there is still no evidence of any *significant* or *sustainable* economic growth ahead.

Erratic Currency Markets

The Loonie has again reached parity with the U.S. dollar, which has been appreciating strongly since early last December. The strength in "both" dollars has principally been against a faltering Euro. A stronger U.S. dollar is the last thing the U.S. needs, with trade deficits still alarmingly high. However, it is with China where tensions are escalating, as the Yuan remains “fixed”, or more precisely, *managed within a very narrow band.* Certain politicians in the U.S. Congress are determined to label China a currency manipulator, seeking to impose harsh penalties. Even noted economist Paul Krugman, strongly argues China must un-peg the Yuan and raise the value of its currency. Krugman recommends imposing a 25% tariff on Chinese goods if they fail to strengthen the Yuan. With mid-term elections near, and with economic patriotism surfacing, confrontation is not out of the question. While these actions do not represent the majority, the protectionist instinct bears monitoring.

Clearly the U.S. needs a lower dollar, without which it cannot compete and will never correct its trade gap. The U.S. needs to buy less from abroad and push for policies that encourage exports and a shrinking of the trade deficit. Currency markets are likely to be erratic as countries seek a competitive edge.

Higher Interest Rates Ahead

Interest rates appear to be heading higher, unless of course the economy proves less resilient when taken off government life support. Should this happen, short-term interest rates may remain under 1% for a longer period of time. Nonetheless, the structure of interest rates cannot remain permanently low, as this would suggest little or no economic growth. With an even modest improvement in the global economy interest rates will be forced up at some point.

The Federal Reserve is now preparing to exit from its quantitative easing program ($1.25 trillion of mortgage backed securities were purchased as part of this program). Already the bond market is getting nervous as interest rates have jumped. Given the money creation we have so far witnessed, efforts by the Fed to withdraw could drive interest rates much higher than expected.

The heavily mortgaged U.S. homeowner is ill prepared for rising interest rates. The U.S. housing market would come under renewed stress. Foreclosures are at record levels and a new round of mortgage rate resets is just beginning. Recent reports on the Canadian housing market suggest many homeowners have stretched and taken on excessive mortgage debt. Higher interest rates would make it more difficult to meet monthly payments as many have opted for variable rate mortgages.

While optimists are convinced the authorities are skillfully steering the post-recession economy, we are less willing to put our faith in government. Monetary policy has and will continue to play a significant role however it cannot keep interest rates artificially low forever. Market forces will act to demand higher interest rates.

Expansionary government policies are lulling investors into complacency. We are in a “sweet spot” where the recovery appears to be progressing fairly well and no one expects any immediate bad news on the horizon. Weaker economic statistics are tolerated and are typically seen as lagging indicators in an improving climate. We suspect there will be little real improvement and the economy will drift into another soft and unexpected period of subpar growth.

Wither Cash

With short-term interest rates near zero levels investors are loathe to hold cash. Still hesitant about the stock market, the bulk of investors' savings are being channeled into bonds. With higher interest rates being telegraphed by government authorities, the returns on bonds looks set to decline. The strong desire to earn higher returns is also driving investors into all kinds of instruments offering a better yield. Safety and often flexibility is being exchanged for riskier investment products, especially those with longer term commitments.

Mutual fund managers have also reduced cash positions. At about 4%, the industry average is now down to historically low levels, an area that has typically coincided with market tops. Cash is now a dirty word. From a contrarian view it is probably a good idea to keep some on hand for a rainy day.

Portfolio Strategy

At the current time we do not recommend a fully invested portfolio position in either stocks or bonds. Accordingly, cash reserves should be at the higher end of the range. Exposure in equities should be at the mid to lower range of the investment mandate. Likewise, bond weightings should be reduced, and/or maturities towards the shorter end of the yield curve.

In addition to these recommendations at the asset mix level, we recommend a more conservative shift within each of the equity and bond components.

In bonds, this still means maintaining a good proportion of the portfolio in corporate bonds to improve yield, but insisting on higher quality credits. The average term-to-maturity should be considerably shorter than that of the DEX Universe Bond Index, the common benchmark used to measure bond performance.

In the equity component the focus should be on larger-cap Canadian equities, and a more defensive weighting in higher dividend yielding securities or exchange traded funds. At this time a minimal involvement in U.S. or international securities is suggested.

For newer client accounts it has been more challenging to structure a portfolio at a time when the market sits at a much higher valuation level. After the considerable rally we have witnessed, a fully invested posture is not recommended. Earlier this quarter it appeared the stock market was heading for a long overdue correction. The pullback turned out to be short-lived and stock prices have once again rallied. In this current quarter we will be looking to increase portfolio positions into either another general market, or a specific sector pullback. We expect the immediate period ahead will be volatile as financial markets adjust to an end in quantitative easing and higher short-term interest rates.

With the financial markets having recovered strongly, the issue ahead is whether the economy can deliver a rapid expansion. The market is already priced for *significant growth* which is going to be difficult to satisfy.