Investment Commentary

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2011 – Summary

2011 will be remembered as a year marked by volatility. All capital markets were very choppy. The S&P/TSX Composite price index ended the year down 11% and in the U.S. the S&P 500 index managed to end flat. The Cdn dollar ended up losing close to two cents for the year. It was the first year in many that the Canadian market underperformed its U.S. counterpart.

The big gainer in 2011 was the bond market, especially at the longer end of the maturity curve. Canadian 30 year bond yields dropped to 3% and 10 year bonds dropped under 2%. The DEX Universe Bond index, a broad benchmark for Canadian bonds, rose by an incredible 10%.

Volatility characterized the commodity markets as well with a wide trading range for the price of Oil and many industrial metals. Gold traded as high as $1,924 before plunging and ending the year at $1,566, still up 10% for the year. It was a nerve wrecking and frustrating year.

Expect Continued Volatility

The European sovereign debt crisis, the primary cause of the volatility, will not be fixed overnight. While the economic urgency is finally understood by politicians, relationships are so strained that it will not be a smooth transition to any permanent fix. Ideologies also widely differ. With that in mind we still believe some kind of fiscal union will occur this year and the proverbial “can” will have successfully been kicked down the road.

Still, we expect more volatility which will annoy and frustrate investors. However, we expect the volatility will remain in a 15 – 20% range, which in essence is similar to what we experienced last year - *and the year as a whole can still end up in positive territory*.
We are probably more optimistic than most when it comes to the crisis in Europe. They are at least finally getting serious about addressing their economic problems. Financial markets appear to be giving them the benefit of doubt, at least for now. In the end Eurobond investors must be confident that they are buying a currency they believe will be in existence a few years down the road. A movement to fiscal union with monetary support from the European Central Bank should alleviate concerns. (The ECB has recently provided 500 Billion in three year loans). Importantly, in aggregate the Europeans have less debt per GDP than the US or

Japan. The Eurozone is economically well diversified and external trade balances are in good shape. *Notwithstanding the occasional turmoil, confidence should build as the year progresses.*

For the U.S., the safe-haven status has again helped in attracting capital at the margin. The U.S. Treasury market and the Dollar have been firm. However it is a relative game. The economic crisis in Europe for the moment only makes the U.S. appear “less worse”. The risks to the Dollar are likely to become more apparent once the European crisis subsides. After-all, U.S. fiscal policy is a mess and Federal Reserve reflationary policies are destined to devalue the dollar.

For all the negative press and pending death of the Euro, the currency has been relatively stable. The Euro is currently trading at 1.3 to the U.S. Dollar, down from a range of 1.4 - 1.45. Throughout the crisis there has not been a massive flight out of the Euro. By this measure the crisis seems a bit overblown.

Money Printing: Avoiding The Pain

We had taken the view last year that a new round of QE, or money printing, would safeguard financial assets. Governments would act preemptively so as to prevent a decline in equity prices and a collapse in investor confidence. In hindsight, we were too optimistic. The economic headwinds had all been telegraphed well in advance. It was the gravity of the sovereign debt problems in Europe with a spike in interest rates, the downgrading of U.S. debt, and more alarm over a slowdown in China which seemed to hit the markets all at once.

At the end of the day we still firmly believe the politicians are more likely to print money than to subject their countries to depressed economic activity and rising unemployment. We expect them to take the easy way out and avoid the pain. Financial markets will benefit from the money printing although the timing is of course uncertain.

Fortunately, there is also some good economic news in the U.S. of late. Manufacturing is starting to improve. Retail sales activity is firm and employment is recovering. A few more months of positive improvement will certainly help to boost confidence.

Deflation Trumps Inflation

We are in a deflationary environment and it appears likely to endure for a good number of years. This stems from decades of accumulating debt to a level which is finally unsustainable. All along there was a positive inflationary feedback loop which encouraged more debt to the “tipping point” we have arrived at today. The longer macro trend is the deleveraging of private debt. Public debt on the other hand will continue to grow as government fiscal imbalances remain challenging.

While long term macro issues are important and often seem obvious, they have a way of obscuring themselves. Deflation is quickly forgotten when markets recover and commodity prices rise. The fear of hyperinflation from excessive money printing adds further confusion. We believe the Central Banks are equally confused, however they do understand the dangers of excessive monetary policy. For now deflation trumps inflation and this will encourage Central Banks to printmoney. We believe policy will be “exploratory”, in the sense that Bankers will take a stop and go approach as they try and keep a lid on creating inflation while fighting the natural deflationary forces of a deleveraging economy.

Portfolio Strategy

We came very close to selling a good number of our equity positions in the final months of 2011. As we said then, we drew a “line in the sand” and were ready to sell up to one third of our weightings. So far so good as prices have re-bounded by a moderate amount from the lows of October.

Investors continue to redeem their equity based mutual funds in favour of bond funds. The same forces driving investors into fixed income securities is also driving them into higher yielding stocks. The market volatility and near zero returns in bank deposits and short term instruments is causing this shift in investor preference. This shift may continue for a longer period of time - even to the point of leading to extreme and uneconomic valuation levels much the same as what happened during the Income Trust fiasco. Nevertheless we are not there yet. While chasing last year’s returns is often not a good investment strategy, our intention is to be prudent and to increase equity positions in higher dividend yielding securities as the year progresses.

The real surprise to date is that corporate fundamentals are still remarkably strong. Profit margins are at record levels and earnings have held up very well in spite of the doom and gloom around the world. This has brought about a contraction in price earnings multiples and made stocks much less expensive than one year ago. Lower valuations could lead to more corporate takeover activity. A recent survey of CFO’s does suggest they are looking again at buying back shares. This is a positive statement and confirms management finds their own company valuations attractive.

We continue to like the Gold companies. Ironically, the average large cap stock fell 10% while the price of bullion rose 10%. In the Oil & Gas sector the larger stocks dropped by 15% while the oil price remained essentially flat. While the focus of investor attention is now on high yielding stocks, these and many other resource companies are priced more attractively and should remain a core part of portfolios.

Still, the financial markets are likely to remain volatile and while we do not foresee a disaster unfolding it makes sense in a zero interest world to emphasize companies that can sustain 3 or 4% dividend yields.
Recognizing it will likely be another volatile year we will also do our utmost to “trade” as often as practical. We also expect at least one half of the stock portfolio will be positioned in the more defensive sectors where dividend yields are high.