Investment Commentary

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2009 – A Recovery Year

It was a year of recovery in financial markets. In Canada, the S&P/TSX index gained a remarkable 35.1%, while in the U.S. the S&P 500 rose 23.5%. The gain in U.S. stocks was a more modest 8.1% in Cdn dollar terms as our Loonie recovered sharply. Vis-à-vis the U.S. dollar it closed the year at .95, up almost 16% for the year.

Commodity prices also recovered. Oil rose to close at $86.00 U.S., having been as low as $35 earlier in the year. Base metal prices rose smartly as did the price of Gold bullion, closing at $1,100 in U.S. dollars.

The bond market had a satisfactory year as long-term interest rates declined slightly and corporate yield spreads narrowed. The DEX Universe index, a broad measure for Canadian bonds, posted a return of 5.4%.

The Debt Crisis

The financial crisis has exposed the enormity of the debt challenge facing the developed world. It is beyond doubt *a debt crisis*. All over the world government budget gaps have exploded as tax revenues plunged and social spending needs rose. With the private sector deleveraging, governments have resolved they must stimulate aggressively to prevent the global economy from imploding. There are hardly any voices of opposition, even though the deficits are quite alarming. Most agree that at this fragile stage, any cuts in spending or increase in taxes to close budget gaps will likely cause a double-dip recession with a further loss of business and consumer confidence. A downward spiral would make things worse and cause deficits to widen even further. With economic stability and unemployment a major concern, governments will keep the stimulus going.

For governments, a good dose of monetary and fiscal stimulus is nothing new. These policy tools have proven to be fairly successful during previous recessions. But are conditions similar today? Will the same expansionary policies work as they have in the past?

In their most recent book, “It is Different this Time”, Kenneth Rogoff and Carmen Reinhart chronicle a history of financial recklessness. Looking back at 800 years of data and spanning 64 countries, the fundamental economic facts are inescapable, and the conclusions very sobering. High levels of compounding debt eventually ruin all countries whether these are smaller emerging nations or larger more advanced countries. Importantly, a country cannot print itself to prosperity, nor is the accumulation of more debt a viable solution. According to 800 years of data, the fiscal path most Western governments are on is unsustainable. We are reminded of the definition of insanity - *"doing the same thing over and over again and expecting a different result!"*

Concern is now building in Europe that Greece may be teetering on the edge of insolvency and in need of financial support. Portugal and Ireland have also come under the attention of EU officials. Their current debt to GDP ratios are well above the Maastricht treaty guidelines. Of course the U.S., U.K. and Japan are also in dire predicament, but for now they are off the front pages. Europe is the focus. Sovereign debt problems are coming at a most inconvenient and unexpected time - *a global economic recovery had become the consensus view*. The risk of another financial setback should not be underestimated. Still, we expect that common sense will prevail and that any hint of a sovereign debt contagion will be quickly diffused.

While Europe is currently under the spotlight it is the U.S. that is at the center of the debt crisis. To finance its growing deficits the U.S. Federal Reserve has stepped in to buy government bonds. Without the generosity of the Fed the deficits could not be funded, or at least not at these low interest rates. With 40% of the budget offside, it will be almost impossible to close the deficit gap anytime soon. In a $14 Trillion dollar economy the annual deficit is equal to almost 12% of GDP. How can the U.S. government increase taxes and/or cut spending by that magnitude without risking another economic contraction? The hope of course is that a gradual improvement in the budget will occur alongside a robust and growing private sector.

It is our view that the debt crisis has only been postponed and will resurface again before too long. Practical long-term solutions are not being addressed. Consequently, the potential for another disruption in financial markets is still considerable. However, we expect the experience learned by events in 2008, and the determination of governments, will put a floor under any fallout in the current year.

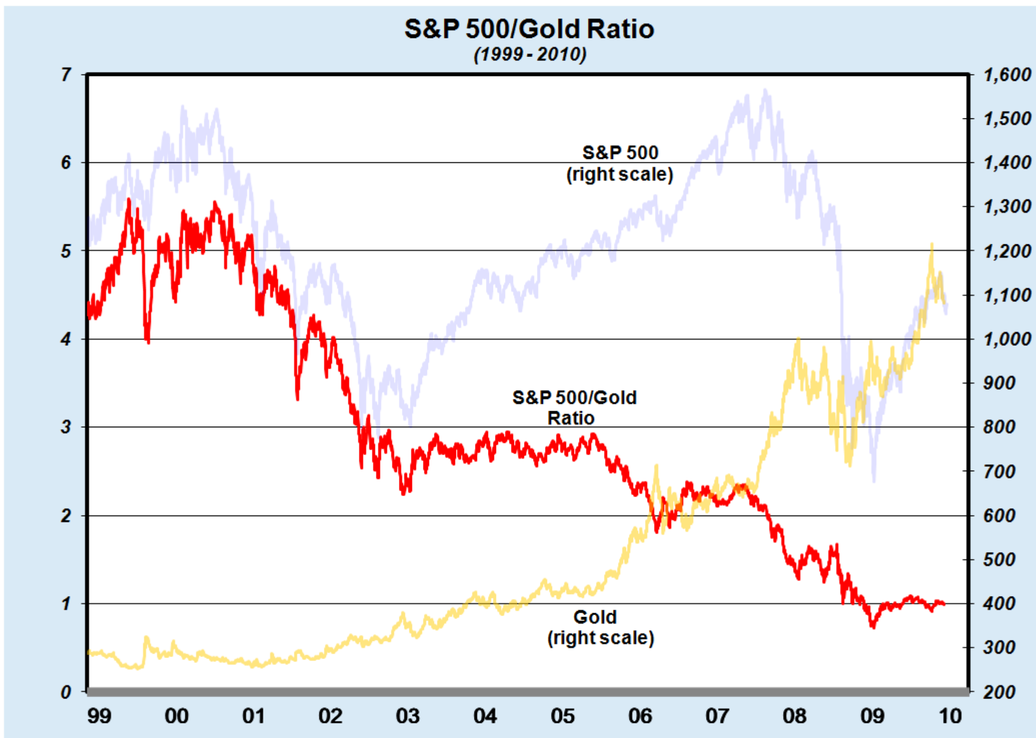
Build It and They Will Come

China's economy continues to impress. By most estimates this will be another year of 10% + growth. China's version of fiscal stimulus has been targeted to infrastructure development - building cities, airports, and unfortunately, bridges to nowhere. Many of these projects are currently underutilized. The stimulus appears to have resulted in overbuilding and while we doubt it will be a long-term problem, there is too much inventory of fixed assets at the moment. According to the statistics bureau - *urban fixed-asset investment jumped 30.5% in 2009*. The empty buildings will be occupied, however a pause is probably required to restore balance.

Investors see a headline figure of 10% growth and take it for granted, assuming healthy and sustainable growth. In a one party system, central planning is efficient at getting things done. What it gets done however may not necessarily be efficient.

Gold

The volatility in the price of Gold bullion continues. It has fallen back from its high of US$1,226, reached late last year. This decline has coincided with the strengthening of the US dollar. Even so, as the chart below indicates, Gold has been in a steady rise for the past decade, far outpacing the returns in the stock market. Over a ten year period the S&P 500 to Gold ratio has declined to 1, and gold has now caught up to match the level of this index. Remarkably, ten years ago the price of Gold was just $250 per ounce and the S&P 500 was at 1,500! This is quite an impressive relative gain.



The gold mining companies have unfortunately not fared as well. The reasons for this can be explained in a rising Canadian currency, rising cost structures for the industry, and to the alternative gold investments available for investors, specifically the gold bullion ETF. While we are frustrated at the lack of better performance for the gold miners, valuations can only improve as the price of bullion keeps rising. Eventually investors will turn their attention to the companies for their earnings and cash flow potential.

Another peculiarity often discussed, though difficult to prove, is that hedge funds are heavily involved selling the stocks and buying bullion. These “spread trades” cause wild swings and there are often days when the stock prices go up while bullion goes down! On other days the stocks lag the rising price of bullion. This is a hedging strategy that can unwind quickly if market dynamics suddenly change. Eventually, we expect stock prices to perform well.

Gold is disliked by politicians and central bankers for the simple reason that it stands in the way of their ability to issue debt and print money *without restriction*. Though Gold no longer plays an official role in the monetary system, it acts as a competing monetary instrument in the private market. With the projections for endless deficits and the huge future costs of entitlement programs, there is a serious funding challenge ahead. The private market will continue to buy Gold in order to hedge against the increasing likelihood of vast money printing and the fear of a huge inflationary impact.

We are also reassured in that behind the scenes a number of central banks are evidently looking to buy more Gold. The governments of China, India, Brazil, and Russia are said to be prepared to add to their physical gold holdings and diversify more of their "paper" reserves.

Reckless monetary and fiscal policy will assure that gold will continue to be accumulated. Gold has already doubled in the past two years. In this unstable environment it can double again in the next year.

A Bubble in Bonds

Incredibly, throughout this recovery in the stock market, the average investor has had a preference for bonds. Investors have directed their savings primarily into fixed income instruments, outpacing the amount invested in stocks by a very wide margin. A desire for safety has investors rushing into bonds.

Even the large pension and hedge fund managers are fixated on bonds. The conventional wisdom appears to be that *deflation* is the far greater risk. With the announcement by the U.S. Federal Reserve that they are buying bonds, the government is signalling it stands ready to keep interest rates from rising. For the moment, an investment in bonds seems like a good low risk strategy. However, in a paper currency system, a long-lasting deflation is simply impossible. There is theoretically no limit to how much money the Federal Reserve can create out of thin air. Those simply looking at the banking system for inflationary clues, i.e. in broader money supply growth, may be waiting a long time and looking at the wrong statistics. If the Fed keeps printing there will eventually be a reaction in the currency markets, perhaps well before any pick-up in loan growth. Interest rates could then climb quickly as investors reverse their previous desire to hold U.S. bonds.

The Fed is determined to rekindle inflation in order to keep asset prices from falling. It is a dangerous game. So far the explosion in base money is not being put into circulation. A policy error in creating too much money is possible as the banking system is not responding in the usual way. Fearing deflation, the Fed may eventually succeed in starting the fires of inflation. The bubble in bonds would then burst.

Strategy

We are hopeful that the lingering global financial crisis will be resolved and that businesses will adjust and move forwards. Policy makers around the world are learning from their mistakes. While they may quarrel over trade and currency issues they will not lose sight of the bigger picture - creating the conditions for growth, innovation and employment. The big risk is in a ***major*** realignment in currencies and in higher interest rates. It appears these risks are being managed effectively for the time being – the U.S. dollar has strengthened and interest rates are low. However these risks can resurface at any time.

We continue to believe the market is overpriced at these levels and that stocks are discounting an overly bullish economic climate. Price/earnings ratios are back well above 20X - a higher risk range which has historically meant poor returns to follow. Our strategy is to maintain a moderate allocation to stocks overall with a heavier emphasis on gold mining and resources generally. Cash reserves are increasingly being invested in the more defensive and higher yielding sectors. With any significant setback, we would look to increase positions and bring portfolios closer to a fully invested equity posture. While our strategy is to buy into weakness, we will remain diligent to any unfolding negative events, which can manifest themselves at any time. Investor expectations are generally more positive and any threat to those expectations could easily cause a retracement in the stock market.

For now we are still in uncharted territory with an economy largely on government life support. As the private sector recovers on its own we will have an idea of the strength in the underlying economy and hopefully some comfort in taking more portfolio risk.