



Investment Strategy Update (Expanded)

February 25th, 2011

Our theme: as long as bond yields are not set to rise as fast as earnings, stocks are the more attractive asset class. Today the disparity is significant. The attached Investment Strategy Update, first published on February 4th has been expanded to include commentary on recent events in the Middle East and the overall level of investment risk.

Fixed Income

The 10 Year Government of Canada (GOC) bond yield is 3.25%, well below the long term average of 5.5%. This makes the asset class less attractive than stocks (where dividends levels rival the cash flow from bonds) and vulnerable to interest rate risk. We've said it many times before and it bears repeating: a 1% rise in interest rates results in an 8% decline in the value of the 'safe' 10 year GOC bonds. If rates go up 2% (as they eventually must) the decline in value is 16%!

There are several factors coming into play over the next 12- 18 months which should push interest rates up - among them: inflation in emerging economies, synchronized global economic growth, pressure from rising sovereign debt risk and the endless issue of new government debt. Several analysts expect stronger economic growth in the U.S. will be the catalyst to change money market sentiment.

None of this will occur overnight --- the Fed is still in the throes of its large scale bond purchase program and the U.S. Administration will not tinker with short term rates (which have edged up in Canada but for now have stalled) for fear of negatively impacting on economic growth. The fear around rising oil prices will likely serve to extend the period of low interest rates. Nevertheless, we have started protecting clients' fixed income portfolios by shortening the duration to approximately 4 years as compared to the 6.2 years for the bond index. Lowering duration reduces bond price volatility and is the frontline defense for interest rate risk. For clients with income requirements, at this time, it will be better to fund spending through capital gains than through interest and dividends.

Equities

Over the past two years, economic growth and company earnings forecasts as estimated by analysts collectively have consistently erred on the side of caution. After much hand-wringing over double-dip scenarios, both the global economy and stocks made enormous advances finishing 2010 on a high note. While some weeks or months in 2011 will be better than others, our expectation is that a strong stock rally should extend into 2012 based on accelerating global economic expansion, strong corporate earnings and growing investor confidence.

The economic and policy environment remains aligned for global growth of 4% or more in 2011. Global growth may be uneven but persistent. On the basis of normalized earnings and price/ earnings ratios, major North American stock indexes are attractive and able to provide total returns exceeding 10%. Corporations also have unusually strong cash positions allowing for reinvestment and long-term profitability and dividend growth. U.S. financials will see sizeable increases in their bottom line as loan loss charges subside and loan demand picks up. Multi-nationals (especially healthcare, technology and energy) which are well represented in the S&P 500 are in the cyclical sweet spot. Canada's strength is the significant contribution of the resource/ materials sector to the TSX Index. Recent Canadian export results in December served to underline Canada's positive exposure and the growing strength of the U.S. recovery.

Risk: Debt and food inflation

A main source of risk comes in two varieties: debt and food inflation. The sovereign debt challenge (Europe, Japan and eventually the U.S.) is important but austerity measures, central bank intervention and a rapidly expanding global economy is assuaging financial market fears. Typically at times such as these, there are analysts who are extremely bearish who project financial collapse if current conditions continue unabated. Reality is much more subtle as inflation, economic growth, currency devaluation, government austerity, rising tax revenues and rising levels of taxation are all factors that will kick in to bring debt levels and financing levels down, though not without much social pain.

The other source of uncertainty is Asia, especially China, whose governments must tread a fine line between fostering growth and curbing inflation. Food inflation will lead to political instability and may beget more radical policies which, in turn, may hamper global growth. China does have the option of allowing its currency to rise (this will reduce the price of food imports and increase supply) is ultimately beneficial to key exporters, such as the U.S., to access the overall rise in

domestic consumption in China.

Risk: the US economy

Unemployment, particularly in the U.S., is a much discussed risk factor. In our view the **S&P 500** and some sectors of the U.S. economy (technology for example) are attractive for reasons that have little to do with domestic conditions and more to do with global economic growth, productivity gains in the U.S. (unemployment is actually a by-product), a lower U.S. dollar and comparative investment opportunities. If we pay attention to housing, unemployment and consumer confidence it's because so many investors and analysts place so much emphasis on it, but given a longer investment horizon, it doesn't shape our investment strategy or factor as a major risk.

Risk: the Middle East and energy

As to the Middle East, no one expected that the death of a Tunisian vegetable vendor could spark regional instability, raise oil prices and temper global investor enthusiasm (for now). The global reaction is reminiscent of the Greek debt crisis of almost exactly a year ago. The similarity lies in the sweeping generalizations and hyperbole surrounding both issues. Just as the Greek situation involves many discrete situations and did not lead to a collapse of the Euro let alone the world's currency system, so too the entire Middle East is not a powder-keg with a short fuse of religious, tribal and political unrest that will completely derail global growth and capital markets.

The citizens of key regimes like Saudi Arabia, the greatest bastion of world gas and oil reserves, unlike impoverished Egyptians, Libyans and Tunisians, are cocooned in great luxury while they are suppressed politically (quite brutally) by state police and a powerful military. Just this week, Saudi Arabia's King Abdullah laid down U.S. \$37 billion in subsidies, unemployment benefits and pay raises to appease his subjects.

Religious tensions as also significantly tempered as Saudi royals share Wahhabism, a strict brand of Islam, with their Sunni subjects while Shi'ites (Iraq is Shi'ite) number less than one million of the Kingdom's of 18 million citizens. Jordan is more like Saudi Arabia though it does have a large Shi'ite population while Yemen is one of the poorest and least developed countries in the Arab world and therefore more like Tunisia and Libya. Yemen's population is also nearly evenly Shia and Shi'ite and open military conflict (ending in a truce in 2010) has raged in northern Yemen for years.

In other words, just as in the Euro 'crisis' some countries like Portugal, Ireland and perhaps Spain had the same risks as Greece, others like Germany, Italy or France were quite different and to some extent were even able to profit from the low Euro. The crisis in Europe has potentially a positive outcomes as it is has forced EU members to confront their currency, fiscal and other financial issues. The Middle East is enormously dependent on continuing oil exports and the economic self-interests of its citizens will restore balance, and quickly. There is a risk that global economic growth may be impacted, but it is neither a certainty nor is it likely to cause a recession. Investors with short term investment horizons will play up the risks to profit from them.

For peak-oil advocates (Jeff Rubin and others) the current Middle East situation is a gift to get their story out again and to announce that this is a watershed moment in the history of oil. While in the long run it is self-evident that the price of energy must rise substantially, for now the evidence continues to confound them. Over recent decades, the consensus estimates of the amount of recoverable oil on the planet have roughly doubled. And recovery rates — the percentage of those reserves that we are technologically able to collect — have grown from 10% a century ago, to 25% a half-century ago, to an estimated 35% now. In some areas, like the North Sea, the figure is above 60%. There are also good reasons to remain calm about Saudi reserves, which are key to global supply. Saudis have discovered approximately 70 major oil fields that are as yet untapped over concerns that increased production would cause global oil prices to collapse. And while Aramco is hardly likely to find anything on the scale of the Ghawar oil field, the world's largest, to date they haven't been looking very hard. The Saudis drilled about 500 wells last year; some 11,000 are drilled every year in the United States alone. When it comes to oil, necessity (and concomitant rising prices), is surely the mother of invention as we have seen in the history of the oil sands. Following the events in the Middle East, the U.S. Administration may well be motivated to allow renewed drilling in the Gulf of Mexico.

Risks: a final word

We take the risks outlined above very seriously but keep them in perspective. At any time specific investments in capital markets are subject to extraneous risks --- political, economic, market or systemic risk. In the fallout of 2008-09, investors have (understandably) become very sensitive to --- and we would argue too fearful of --- those risks and this is why we have devoted so much space to provide a perspective on those issues here. Additionally, stocks of late, particularly in the

U.S., have been blazing ahead, and are vulnerable to an adjustment as investors sell to protect their recent gains. These factors do not alter our basic investment premise: interest rates are low making fixed income investments vulnerable and unlikely to provide decent returns over the next several years, while stocks (as an asset class) are attractively priced and set to rise as earnings and cash reserves grow on the strength of a broad and synchronized global economic recovery.

This strategy aside, our first and most important line of defence (and yours) is to invest in balanced portfolios of blue chip stocks and bonds in mature capital markets, to insist on broad diversification and to work with reasonable investment horizons (+18 months). Such an approach is less likely to be derailed by emotions (yours or ours) and resulting portfolios, because of the quality of the holdings, have very little chance of losing value permanently though they are not immune to volatility (as we all saw in 2008-09).

Asset allocation strategy

As always, investments emphasize quality and liquidity. Client portfolios today are tilted 60% - 65% to stocks, 5% - 10% to alternatives (which includes REITs, commodities and gold bullion) and to 25% - 30% fixed income. US\$ investments remain hedged against the strong Canadian \$. We regard market pullbacks (for example, now) as buying opportunities.

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