

- **Why are investors so focused on the short term? Why did the economist apologize?** The coming of the electronic age has had an enormous impact on financial markets and on investing: above all, capital markets have become more efficient and harder to beat. Ironically, the new technology with its abundance of information, new financial products, instant analytical tools and direct access to trading, provides a false sense of security in numbers, analysis and how it might be easy to beat the markets. The abundance of information (much of it thinly disguised promotional material) invites constant action and reaction as it pours in. Investing has been accelerated and has become speculative and very focused on short term gains. With such a fixation on the short term, investors have necessarily fallen under the influence of whole host of sincere and well-meaning economists, strategists, analysts and investment gurus (usually with no professional investment management experience or training) offering instant analysis and advice much of which is later proven wrong or at best not useful. Paying close attention to all this noise --- everyday single day! --- simply because your cell phone can do it anywhere in the world, does not promote a focus on strategy or on long term results: it promotes action and reaction often unnecessarily. As a slight aside: economists, eminent or not, do not owe the **Queen of England** an apology for not *predicting* the financial crisis: they cannot see the future and we are foolhardy to think that they ever could.

- What it is to be an **agnostic investor**? It is to be skeptical of all predictions (including your own), to maintain a balanced portfolio by asset class, and to use highly diversified market tracking instruments with --- and this is key --- a view to expecting mean rates of return and measuring performance over longer periods (1 year or more) rather than on a weekly basis. Markets are viewed as efficient, but not necessarily rational, nor always transparent, which is where the risk lies. An agnostic will track global economic and financial events and pay close attention to proven reliable benchmarks (such as interest rate spreads or even P/E ratios) and cyclical indicators, though rarely should any single event, report or analysis trigger action. Adjustments to a portfolio are part of a semi-annual process (not because an economist says so) of restoring balance (by selling winners and buying losers). What is the agnostic's advantage? For **Her Majesty**, the Royal portfolio would be in much better shape and the Royal sleep, far more restful. The benefit of the agnostic approach is that it controls what we call '**manager error**' (think of it as human error or emotion), does not permit speculative investing or thinking and relies on the market's cycles, integrity and efficiency to deliver long term returns. In the present market downturn, as long as any systemic breakdown was averted (which it was), capital markets must eventually revert to normal or mean rates of return and therefore balanced and diversified portfolios which mirror capital markets, will do likewise.

- **P/E ratios are declining, a positive sign:** The **S&P 500** is hitting new highs for 2009 and is now more than 40% above its March 9 low of 676.5. Usually at the end of recessions, price/earnings ratios expand. Over the past weeks however, valuations have instead become more attractive. Today the **S&P 500** is trading at 12.6 times 2010 earnings, the **S&P/TSX** at around 12.8 times. Two months ago, the **S&P 500** was trading at 12.8 times 2010 earnings, the **S&P/TSX** at 13.3 times. The observed decline in P/E ratios is because analysts have been revising their estimates upwards because they were so wrong ---- something we have commented on before and according to **Thomson Reuters** this applies to over 77% of estimates for US stocks! Just shows how wrong consensus forecasts can be.

- **US investors are putting their cash to work.** The **Investment Company Institute (ICI)** reported this week that US money market mutual funds had an outflow of US\$116 billion in June, the largest monthly outflow on record. Close to half of this sum was redeployed in long-term funds with taxable bond funds being the main beneficiary followed by equity funds. Even after this move, more than 36% of total mutual funds assets (which totaled US\$10 trillion in June) are still held in cash leaving plenty of room for other big moves in 2009. Trends in Canada are similar.

- **Healthcare spending and the US consumer:** While the world has been looking askance at US consumers for their freewheeling credit addicted spending on cheap Chinese imports, reality is more complicated because of health care costs. In 2008, the US spent approximately 17% of GDP on health care (nearly twice what other developed countries like Canada spend). The burden on consumers is significant, for example: 50% of all US personal bankruptcy filings are partly the result of medical expenses; more than 25% of mortgage and rent defaults resulted from medical debt; and, retiring couples today need at least US\$250,000 in savings just to pay for basic medical coverage. Doesn't that make you feel good to be a Canadian citizen?

- **The US consumer and global growth:** clearly the US and the global economy are looking for new sources of growth to replace the US consumer. At this time there are significant (and unsustainable) global imbalances between emerging nations and developed countries in trade, savings rates and currency valuations, so we expect as these factors necessarily adjust that growth in US exports, US savings and a decline in the US\$ relative to other currencies will occur. Economic sectors such as technology, pharmaceuticals and healthcare, paragons of US economic strength and

additionally, global brands, which are overwhelmingly resident in the US and in Europe, are well positioned to take advantage of this change (over 48% of S&P 500 company revenues are already derived from intentional sales). This is the opposite of decoupling: this is about more 'coupling' amongst the same partners but trying out new positions! 'Stimulative' monetary and fiscal policies (including those to increase domestic consumption in China) serve to accelerate the process. The picture is not all rosy: there is a real risk that change may trigger inflation, trade conflicts and disrupt global currency markets so it's not a slam dunk. Conversely, the stress may eventually result in greater global cooperation. Regardless, it's an interesting story to follow and a reason to maintain a global portfolio.

-US housing: New sales jumped by the largest amount in almost nine years, up 11% in June though prices were down 12% from a year earlier confirming the affordability of US housing (it is now the most affordable it's been since the 1970's, see March 31 newsletter). **TD Securities** economist **Millan Mulraine:** "In fact, it is hard not to get a tad bit excited about the outlook for the U.S. housing market, as it appears that U.S. home buyers may be beginning to take advantage of the favorable buying environment, particularly given the low mortgage rate, affordable prices and the many inducements coming from the federal government."

-The recovery in housing has direct impacts on other sectors: Take **US Steel Corp.** for example, is recalling 800 workers to its mills in Illinois to churn out flat rolled steel for domestic appliances and cars. With consumer goods priced to sell like never before and interest rates at all time lows, *a US recovery is not nearly as fragile as many would have us believe.* It is hard to dismiss other warnings that we've alluded to before: (1) the US housing crisis is exaggerated with the nationwide decline in housing prices having little effect on homeowners in 34 of 50 states (see our newsletter of April 20th) so the US consumer should not be counted out completely even though their spending ways may be tamed by a desire to save and; (2) that in every recession are buried the seeds of the coming recovery. For example, as demand for minerals and metals collapsed, so mining companies slashed spending and cut production creating the conditions for a deficit in supply which can trigger an explosive reaction (see February 2nd) to meet renewed demand. Much the same is predicted to occur in North American automotive markets which have fallen so far that production this Fall is projected to jump over 50% (see June 15th) providing an extraordinary boost to GDP growth here and in the US. Add to that the enormous economic stimulus package (so big we suspect it will never all be spent), and it is unlikely that the nascent recovery will sputter and fade quickly as so many analysts fear; rather it will gather strength, if not speed as well.

- Hedge your real estate: Last week a new ETF (ticker symbols: UMM and DMM) based on the **Case-Shiller Housing Index** (a measure of house values in 10 leading US urban areas) began trading on the **NYSE**. Housing and real estate returns have low correlations with many other asset classes and this offers a direct opportunity to diversify into the US\$20 trillion (and this is the value after the bubble burst) real estate market. For hedgers (people who already have serious exposure to real estate including in their homes, for example, the **Queen of England**) this is a first chance to benefit from upside gains (UMM is housing long) or protect against the downside (DMM is housing short) without actually selling your real estate. Add this one to the tool bag other useful ETFs like the Deutsche Bank commodity index.

-S&P TSX is narrow and risky: The top 10 companies on the **S&P/TSX** represent about 37% of the main Canadian market. The winners are: **Royal Bank** (6.3 per cent), **TD Bank** (4.6 per cent), **Bank of Nova Scotia** (4 per cent), **Encana** (3.7 per cent), **RIM** (3.6 per cent), **Manulife** (3.6 per cent), **Canadian Natural Resources** (2.9 per cent), **Barrick Gold** (2.8 per cent), **Suncor Energy** (2.8 per cent) and **Potash Corp.** (2.6 per cent). In this kind of a market, a bad event for one company will hurt the broad market, or worse, if it drags down the sector peers as well.

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