

World Industrial Production: According a recently published economic update from **National Bank Financial (NBF)**, world industrial production is surging with output growth of 1.2% in January, a tenth monthly increase. January also marked an important turning point as growth was led this time by industrialized economies with a 1.5% increase during the month, the largest monthly increase since at least 1991. Not only that, **NBF** also points out that the annual increase in world industrial production *is the strongest ever* as world industrial activity now stands only 3% below pre-recession levels. In spite of favourable reports such as this one, many economists and forecasters remain wary that the recovery is sustainable. Well, in our view, for 2010, accommodative monetary and fiscal policy has unleashed a tiger and our portfolios remain stock-heavy.

World: A very pronounced "V" shape recovery in IP



NBF Economy & Strategy (data via CPB)

Greece: This story has legs. As expected, **European Union (EU)** partners and the **International Monetary Fund** have muddled through and agreed on a financial backstop for **Greece** valued at approximately €22-billion (U.S. \$29.2 billion). Interestingly, other heavily indebted nations, such as **Spain, Ireland** and **Portugal**, are contributors perhaps in the hope that the **EU** will consider their future pleas for assistance favourably. Bond and currency markets will likely continue to be driven by the 'pan-European debt crisis' and it may become more interesting as we get details on the creative debt 'restructuring' exploits of various governments with the assistance of **J.P. Morgan, Goldman Sachs** and others. A heated trans-Atlantic debate over regulatory failings and the fiscal behaviour of governments is sure to follow just in time for markets to take a closer look at the indebtedness of U.S. states (e.g. **California**) and municipalities. In this climate, prudent investors should neither be overly alarmed nor complacent: for example this is not a good time to be chasing yields or, with very few exceptions, buying bonds not issued in Canada.

Pacific Investment Management Co. (Pimco): No one really needs more reasons to treat bond investments with caution. After all, there's the European debt crisis and looming rate increases --- and then there's **Pimco's** decision last December to launch, for the first time, its own stock funds. Why? **Pimco**, after all, under Bill Gross's leadership, has become the

world's largest bond fund. "Bonds have seen their best days," says Mr Gross. He expects that excess borrowing by nations including **Britain, Japan** and the **U.S.** will lead to inflation. "We are focused on spread rather than yields. Durations should be kept shorter," he said. "Real interest rates are moving higher. That's the main bear element in the bond market." We agree with that sentiment, and we've made moderate changes to our bond portfolios. However, because small errors make for big losses in bond portfolios, we think it's prudent to make gradual adjustments as double-digit inflation and steep changes in the yield curve is still a ways off.

Caution: prosperity ahead! Really, we're very happy to see the overall improvement in economic indicators. Invest in stocks while earnings are rising but be aware that with the return of normality, especially in credit markets, and prosperity, rates must go up and so bond portfolios are vulnerable in 2010 - 2011.

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