

Which 'experts' to believe?

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"What the 'hell' is going on? One day it's up and next day it's down. Can't the market make up its mind?" ---- all summer, in cottage country or at truck stops, this conversation has been replayed without a satisfactory outcome. Here's a summary of the debate as it's been verbalized in financial media. Note: bad news sells well and the 'double dipper' camp have been the more cohesive and louder group by far, which doesn't necessarily mean they are right.

	The 'double dippers' and bears	The 'others' (the market strategists?)
Perspective	<ul style="list-style-type: none"> - The drop in U.S. yields across the Treasury curve (for various bond durations) suggests that the economy south of the border is in for several years of slow growth, if not outright deflation. - The developed world is de-leveraging (getting rid of debt), consumer demand is very fragile. We are in period of un-winding the 'excesses of a parabolic credit cycle' (i.e. there is way too much debt) and the problem is structural (e.g. aging population) and will not respond to fiscal quick fixes. - Economic growth in the U.S. is unsustainable: it was only a blip --- a re-stocking and a publicly funded exercise. - U.S. unemployment is likely to remain high for the foreseeable future. Housing market in the U.S. is still a mess. - Alan Greenspan: "The US economy is in the middle of a pause in a modest recovery that feels like a 'quasi-recession,' and if home prices start falling again, we could be facing a double-dip recession. It's touch and go." - Growth in China is slowing. - Europe is awash in government deficits and its economies (except Germany) are stagnant. - Japan is washed-up. - Canada is far from immune. 	<ul style="list-style-type: none"> - The pessimism born out of the recession and market collapse in 2008/09 is fear-based and overdone. The recovery, says James Grant, "will jar people ... it's going to be surprisingly strong 10% is not implausible next year." - The villain of the piece is the Fed whose ill-conceived policies helped foster a credit bubble. Now that the bubble has burst the Fed transferred U.S. \$1 trillion to its balance sheet as it engineers (in the best manner of a command economy) a recovery with more quantitative easing reserved for later. - Statisticians confirm that monthly data is unreliable (e.g. the recent flap over Canadian unemployment numbers not being seasonally adjusted) and subject to significant revisions. - Many economist and statisticians confirm that global growth in 2010 is running at a +4% pace and, coming as it does, from several regions and sectors, has enough momentum to absorb the various crosswinds and mini-crises (e.g. Greek debt, China <i>slowing</i> to 9%). - U.S. manufacturing output is very strong as is investment in new machinery and equipment. - Reported earnings continue to exceed expectations. - The Canadian economy is firing on all cylinders as both export and domestic demand is robust. - All the talk about a double dip is harming investor, consumer and business confidence and may result in a real short-term negative impact.
Investment advice	<ul style="list-style-type: none"> - Many folks walk away with the sense that under these circumstances they might as well stuff the cash under their mattress. Nothing is safe! That isn't what the 'double dippers' are saying, far from it. - Embrace bonds, (including those with longer terms because Treasuries and 2 year debt offer virtually nothing), and other income generating investments, including corporates, prefs and trusts. Generating cash is imperative in a bear market. Corporate bonds are offering attractive yields and are priced relative to corporate balance sheets (which is good) not to corporate profits (which probably will disappoint). - Now's not the time to be overweight stocks. - Investments made in U.S. dollars should be hedged to the Canadian dollar to eliminate 	<ul style="list-style-type: none"> - Equities today are a contrarian's dream situation! Investors should nevertheless seek safety in diversity by investing broadly across asset classes (bonds, stocks, gold etc.). - Treasuries are not risk-free: they are priced to a certain outcome, but what if that outcome does not come to pass? Shy away from all bonds with a longer term to maturity. - Stocks are attractive because stock dividends are intrinsically high while bonds yields are at historical lows. Since 1962 the dividend yield on the S&P 500 was approximately 50% of the 5 year Treasury bond yield. Today, the index dividend yield is 112% of the 5 year bond yield. In other words, the S&P 500 index annual dividend income alone is 12% higher per year compared to a 5 year bond. This is similarly true of Canadian dividend stocks.

currency risks which could be significant in this cycle.

-The **S&P 500** consensus operating earnings are forecast to rise by 44% in 2010 and 16% in 2011. Strong earnings momentum is the catalyst for higher share prices and market recovery – don't miss it!
- Note: We strongly recommend Canadians invest in the **S&P 500** using Canadian dollar hedged Exchange Traded Funds to shelter the investment from currency volatility.
- Gold is the reciprocal of the world's faith in money and central bankers (Bernanke, Greenspan, Trichet et al) and it's cautious to hold some (5% or so).

Our take away from this debate is:

- Investors hate uncertainty and would rather not invest until they 'know' and so they hunger for information. Such is human nature. Unfortunately by the time they 'know', so does everyone else, and risk missing much of the gains.
- In times of uncertainty, investment horizons become *very* short while in good times the feeling is that 20% returns will go on forever. The opposite is in fact true.
- No one knows what's going to happen in 2010, 2011 or beyond so it pays to be cautious whichever way you lean.
- To the most experienced managers, be they double dippers or bulls, the current debate is not whether they (a) pull all of their clients' money out of the markets or (b) place it all in stocks. The debate is far more nuanced than that: it is whether the right asset mix is 40% stocks or 60%? Is the optimal duration of a bond portfolio 3-4 years or 8-9 years? Where is the U.S. dollar heading and how to profit from or guard against it? What happens to gold and how much to invest in commodities? At this level too there is a lack of consensus, but the discussion is far less emotional.

We are of the view that for most investors (which includes us), with a 2-3 year horizon, the most easily-understandable and pragmatic solution is to hold the major index-tracking Exchange Traded Funds (ETFs) in a well diversified and balanced portfolio. Use your own common sense to pick a fairly neutral asset mix (i.e. allocation to stocks and bonds) while paying close attention to the underlying holdings, *and then stick to it* knowing that for most 2-3 year periods a balanced allocation to stocks and bonds (60/40) will result in an annualized return of 7% - 8%. If you can't do that, as your astrologer, we advise you that you will probably find this is a very difficult period in your investing life.

For more info call Mark Kryzan or Terry Shaunessy at 403-802-3108.

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