

Review

Reality Check

Volatility returned to global equity markets during the second quarter for two main reasons: softening U.S. economic data and the sovereign-debt crisis in Europe, both of which raised doubts about the strength of the global economy. Stock investors balked and sought the safety of U.S. government bonds. Weaker-than-expected U.S. economic data gave rise to more talk about the possibility of the dreaded double-dip recession. Concern that the European Union was moving too slowly to contain the Greek debt crisis only added to investor anxiety, especially because other European economies were perceived to be similarly vulnerable. Many believed that equity prices had gotten ahead of themselves anyway, having rebounded more quickly from the financial crisis than anyone thought possible 15 months ago. The **increased volatility created more uncertainty** and put downward pressure on stock prices worldwide. All major markets declined between 5% and 10% during the quarter (expressed in Canadian dollars).

Another factor last quarter was concern about **the strength of the Chinese economy**, which is viewed as a primary engine of future growth globally. In late June, China finally agreed to allow its currency to appreciate modestly against the U.S. dollar, which will help reduce trade tensions but which, unfortunately, will also tend to hamper their manufacturing sector in the near term. There was also

uncertainty about China's ability to contain a potential real estate bubble while maintaining robust growth. These factors contributed to a decline in Shanghai's stock index of 23% in the quarter. On a more positive note, large "insider" shareholders of Chinese companies were net buyers of stocks in May for the first time in nearly two years, demonstrating their optimism about the future. This reflects the difference in behaviour between short-term traders and long-term investors.

In Canada, economic data was somewhat mixed during the second quarter, raising the question about another interest rate hike in July. The Bank of Canada raised rates ¼% in June, making its **first move to a more neutral level** in nearly three years. Central banks in the U.S., Europe and Japan have not yet raised rates, remaining "on hold", given the uneven pace of growth. Even Australia, which has raised rates 1¼% since October 2009 to cool housing prices, left rates unchanged at their latest meeting.

In fixed-income markets, the expectation of slower economic growth was positive news. Bond investors welcomed the prospect of more modest monetary tightening by central banks, and bond prices rose during the quarter. The short-term bond price index rose 1.7%, leaving five-year Government of Canada bonds yielding less than 2½%.

Following are the returns for the major indices for the period ended June 30, 2010:

	2 nd quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (DEX 30-Day T Bill)	0.1	0.2	1.7	2.5	2.8
Canadian Bonds (DEX Short Term Bond)	1.7	4.3	6.3	4.6	5.6
Canadian Stocks (S&P/TSX Comp.)	-5.5	12.0	-3.9	5.5	3.3
U.S. Stocks (S&P500)	-7.5	4.4	-9.9	-3.6	-4.8
Non-North American Dev. Stocks (EAFE)	-10.2	-3.4	-13.5	-2.0	-3.1
Emerging Markets Stocks (MSCI Emerging)	-4.3	12.4	2.6	9.5	6.7

All returns in Canadian dollars. Source: SS&C Technologies and PalTrak

Outlook

No Man is an Island

The recent string of disappointing economic data has left decision-makers grappling with a global recovery which is more tepid than they had hoped. The recent G8/G20 meetings were focused on one key question: **“When is the right time to cut back on stimulus spending?”** A premature move would be akin to pulling the rug out from under the tentative recovery. But wait too long and one may become the target of angry bond vigilantes, whose wrath was wrought on all of Europe in May when they dumped financial assets indiscriminately in response to fiscal inaction in Greece. This is strong evidence that countries are more interconnected and co-dependent than ever before, and it certainly complicates matters. One country’s decisions will help or hinder everyone else, so coordination and cooperation are essential, if difficult to achieve. If anyone doubted it before, after May’s action this new reality is crystal clear to all policymakers, which in itself is a hopeful sign for the future.

In this challenging environment, the question investors have is: **Where do we go from here?** The market sell-off, if overdue, has been disconcerting and projections of slower-than-expected growth and growing government deficits are not encouraging. Nevertheless, we think it is very unlikely that stocks are falling back into a 2008-style bear market - a time of severe stress caused by an almost total collapse of the world’s financial system. Personal debt and government deficits do remain a concern and may well cramp economic growth for the foreseeable future, but they are not expected to send markets into dire straits. Media pundits may tend to preach otherwise, but as an aside, we note that even the most widely-followed *pessimists du jour*, including Nouriel Roubini and David

Rosenberg, have adjusted their outlooks recently to dismiss the likelihood of a double-dip recession or worse.

On a constructive note, central banks, lending banks and bond markets will keep the cost of capital low as long as inflationary pressures are weak and until a more robust recovery is in place. For example, the recent equity market correction was followed by a significant decline in government bond yields and lower mortgage rates. Also, **corporate profitability has rebounded and balance sheets are very strong** with cash reserves accumulating to levels not seen since 1960. This has been achieved through painful corporate retrenchment which started during the 2008 recession, and it continues because of a cautious spending stance being taken in view of uncertain consumer demand going forward. As cash builds, shareholders will eventually pressure companies either to reinvest in business initiatives for future growth or to increase shareholders’ value through **higher dividend distributions** or share buybacks.

We have regularly noted in past comments that this will be a subdued recovery with bouts of market volatility as the economy finally gains flight. We recognize the challenges investors have weathered over the past decade: two severe bear markets (2002 and 2008) which have sorely tested anyone’s ability to sustain the discipline of an appropriate, prudent investment plan. But the day will come when stocks consistently outperform bonds again and markets restore their normal relationship.

In Praise of Dividends

In the meantime, stock holders might remember they are currently receiving **dividends at a yield level which materially exceeds that offered on government bonds**. This is a big deal. For instance, Milestone's equity portfolios are offering a current dividend yield of almost 3½%. In non-registered accounts, this equates to an **after-tax yield in excess of 4%**, including the tax benefit available on the shares of Canadian companies through the dividend tax credit. In other words, an investor needs to find the equivalent of 4% on a bond, GIC or savings account to do as well as the yield on stocks, on an after-tax basis. This is pretty much impossible to do. For example, ten-year U.S. Treasury bonds yield less than 3% and **five-year Government of Canada bonds yield approximately 2½%**. We believe these dividends are very secure and in time will grow for reasons noted above, even in a sub-par economy with GDP growth below 3%. Overall corporate profitability is approximately twice this 3½% dividend rate, which should translate into tangible capital gains once the economy regains solid footing. **This is the unheard good-news story, which is being lost currently in the loud, unpleasant noise of price volatility**. And we continually search for additional

opportunities to increase these dividends in a responsible, globally-diversified manner.

Finally, while it may not be very attractive from an income-generating standpoint, the fixed-income component of portfolios is meeting an essential objective of portfolio management: **safety of capital in volatile times**. For the time being, we continue to favour GICs in those portfolios where liquidity is not a priority because they offer yields more than 1% to 1¼% above government bonds. It's an exceptional yield spread, but GICs cannot be sold before maturity. We are maintaining a balanced maturity schedule, with staggered terms out to five years. Given today's historically low interest rates, we look forward to the day when investors question the sense of these positions, because it will mean interest rates are rising in the face of strong economic growth! When that happens, pending maturities will be reinvested at materially higher interest rates and the bottom-line portfolio values will have been bolstered by a sustainable rebound in equity prices.