

## Review

### The effects of strong commodity prices – good and bad

Most global stock markets continued their advance in the first quarter, despite violent political upheaval in the Middle East and the devastating earthquake and tsunami in Japan. Although these events caused short bursts of negative market turbulence, for the most part investors remained focused on evidence that **the global economic recovery is gaining momentum**. In the U.S., the Dow Jones enjoyed its best first-quarter return since the booming technology days of 1998. It rose over 6% as improving employment figures and a stabilizing housing market propelled stocks higher. Here in Canada, surging oil and gold prices helped push the TSX up by a similar amount. Not surprisingly, international and emerging market stocks lagged last quarter. The Japanese stock market dropped over 17% immediately following its earthquake and subsequent nuclear crisis but rebounded strongly toward the end of the March. Overall last quarter Japanese stocks declined about 5%.

Rising commodity prices continued to support the Canadian equity market. It is important to realize that **close to 50% of the TSX index is now comprised of energy and material stocks**. This combined with the relative strength of the Canadian economy helped push our dollar higher against both the greenback and the Euro, muting the

returns for U.S. and international equity investments in Canadian-dollar terms.

With the likelihood of deflation subsiding, central banks started to focus on **the threat of future inflation**. Indeed, one of the catalysts for the uprisings in North Africa and the Middle East was soaring food prices. Although most central banks remained on the sidelines, debate intensified about the appropriate time to begin tightening monetary policy. With interest rates still sitting at historically low levels, the European Central Bank raised their rates by ¼% this month, despite ongoing debt problems in Portugal and other Euro countries. They cited worry about inflation as a main factor.

In fixed income markets, **bond yields increased** amid expectations that interest rates will be on the rise in coming months. As a result, bonds continued to underperform stocks during the period with the short-term bond index up a meagre 0.3%. Long-term bonds fared worse and declined over 3%, their prices being more sensitive to changing interest rates. Real return bonds rose marginally because their inflation component offset the decline in prices seen on regular longer-dated bonds. Five-year Government of Canada bonds now yield about 2.9%, up from about 2% six months ago.

Following are the returns for the major indices for the period ended March 31, 2011:

	1 <sup>st</sup> quarter actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (DEX 30-Day T Bill)	0.2	0.6	0.9	2.2	3.1
Canadian Bonds (DEX Short Term Bond)	0.3	3.4	4.5	4.9	5.4
Canadian Stocks (S&P/TSX Comp.)	5.6	20.4	5.0	6.0	8.7
U.S. Stocks (S&P500)	3.5	10.7	0.5	-1.1	-1.6
Non-North American Dev. Stocks (EAFE)	1.0	5.7	-4.8	-2.3	0.4
Emerging Markets Stocks (MSCI Emerging)	-0.3	13.4	2.4	6.7	11.6

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

## Outlook

### Is it time to remove the word “cautious” from “cautious optimism”?

Recent economic data is supporting the view that sustainable growth is underway, even in the face of inevitable challenges. For example, recent U.S. reports on retail sales, consumer credit, exports and business investment are all showing signs of strength. Even the closely scrutinized U.S. employment data (typically a lagging indicator) is now gaining traction. Both February and March posted **private-sector job gains of over 200,000** even as a continued fall in government employment occurred. These numbers were strong enough to lower the U.S. unemployment rate to 8.8% from more than 10% in October 2009. The U.S. housing market is the remaining sore spot, but with the ongoing unwinding of inventories (both new and existing homes) and growth in employment, this sector is expected to finally show real improvement as the year progresses. Because of the overall positive tone to the data, there is now growing expectation that the U.S. Fed will soon begin to unwind its so-called QE2 (Quantitative Easing) program, implemented last summer.

The Canadian economy is also posting strong economic growth, particularly in relation to other developed nations. Estimates for GDP growth in the first quarter of 2011 are 3.8%, following a level of 3.3% in the last quarter of 2010. Household spending and business investment are improving and will tend to “pick up where the government leaves off”, so to speak. Overseas, Europe is also showing signs of strength despite its debt and deficit problems, prompting the ECB to raise interest rates in the hopes of subduing inflationary pressures. In Japan, the devastating effects of the earthquake have definitely cut first quarter GDP markedly, but second and especially third quarter numbers should be boosted by rebuilding efforts. Unfortunately, the tragedy will put additional pressure on an already-strained fiscal situation in Japan and further limit their ability to address ballooning debt problems.

Overall, the year-to-date economic statistics are encouraging and this has translated into a **stronger corporate profit outlook for 2011**. This trend, together with the increasing distance from 2008-2009’s financial crisis, is helping build consumer and business confidence. Going forward, additional spending and investment is likely. This is welcome news for stock markets and is normal for this stage of an economic cycle. What is not normal, however, is the amount of outstanding government and consumer debt that still must be paid down. It’s a reality for consumers and governments alike that will put a considerable damper on growth potential going forward. Fiscal restraint will be required for years to come, making markets more susceptible to flair-ups and pitfalls along the way.

One important signal of a healing economy is the re-emergence of **higher interest rates**. This stage has now begun, with slightly higher yields now in evidence in bond markets. We view this as an encouraging economic sign, but it does result in lower bond prices on existing holdings. We are managing this normal and expected stage of the cycle by keeping bond portfolios short, with the expectation of holding to maturity and reinvesting at higher rates. This means the downside risk on price is mitigated by owning shorter bonds and GICs staggered out from one- to five-year terms. Then, as maturities take place, we will be able to lock in higher rates, improving fixed-income returns over time. With respect to strategy, we are now focusing less on GIC purchases and more on bonds, as rates on bonds are becoming more attractive and also provide more flexibility over GICs. (Bonds have the option to sell before maturity should the need arise.) Current rates on preferred shares are also attractive, particularly on an after-tax basis, and justify

taking some positions in taxable accounts. It should be noted that the tax advantages on Canadian dividends are becoming somewhat less attractive due to recent changes in federal tax legislation. Nevertheless, high-quality issues remain beneficial, providing the after-tax equivalent return of a 6% to 7% interest rate, depending upon an individual's marginal tax rate.

As you can see from the chart on page one, **stocks have done very well over the last year**. Even so, in this environment of ongoing global recovery, equities remain attractive on a valuation basis. Corporations stockpiled excessive cash reserves during the bad times and are now in a position to increase dividends or employ share buy-backs or hire new employees or expand operations or all of the above. Their spending should further reward investors and augment economic stability. We expect stock returns may moderate after such strong advances, but should still provide superior rates of return relative to bonds and other asset classes, such as real estate and gold. Also, we suspect that a

change in "market leadership" is ripe, with Canadian and Emerging markets taking a back seat to the U.S. and developed international markets.

Finally, election season is upon us with the Canadian federal election in May, an Ontario provincial election this fall (possibly other provinces to follow) and a U.S. federal election next year. Of course, elections are significant events that should command our attention and participation. We don't have to look too hard these days to see those who are willing to die for the right to vote, something too many of us take for granted or ignore altogether. Markets also pay attention to elections, but rarely alter their course for long because of one outcome or another. Rather, it is the outlook for changes in **economic data, corporate profits and interest rates that will always be the primary drivers of financial markets**. And it is interesting to note that governments are finding they also must operate within the confines of the real economy as well, or face the consequences.