



# Compass



Facilitating Excellence in the Management of Wealth

## Summer 2010

### Investment Commentary, Q2 2010

In his book *The Fortune Sellers*, author William Sherden researched the record of economic forecasters. To summarize his findings, forecasters were about as accurate as guessers or dart-throwers. Nevertheless, media continuously rolls out various “experts” with their carefully structured economic or market predictions.

At the moment, investor anxiety surrounds deepening concerns from economist predictions over future economic activity. Of course, bond, stock, and commodity markets are all discounting

mechanisms of future events – and at the present time, they are feeding on predictions and painting a grim picture. U.S. consumer and manufacturing-related indicators are pointing towards a notable slowdown in output in the second half.

Markets in the second quarter were filled with this fear. European debt came under suspicion, and waves of negativity flowed through the global bond, currency, commodity, and stock markets. As fears increased, capital investment quickly moved back towards US

“safe haven” investments as shown below.

Looking back, as we entered this year our thoughts were clearly focused on the rebound in equity markets off the March 2009 low, and filled with expectation that rising interest rates – on the back of escalating government debt following more than twelve months of quantitative easing (printing more money) – would drive bond returns down. We expected muted market price growth overall (though with much greater volatility) in both stocks and bonds.

#### AS FEARS ESCALATE...

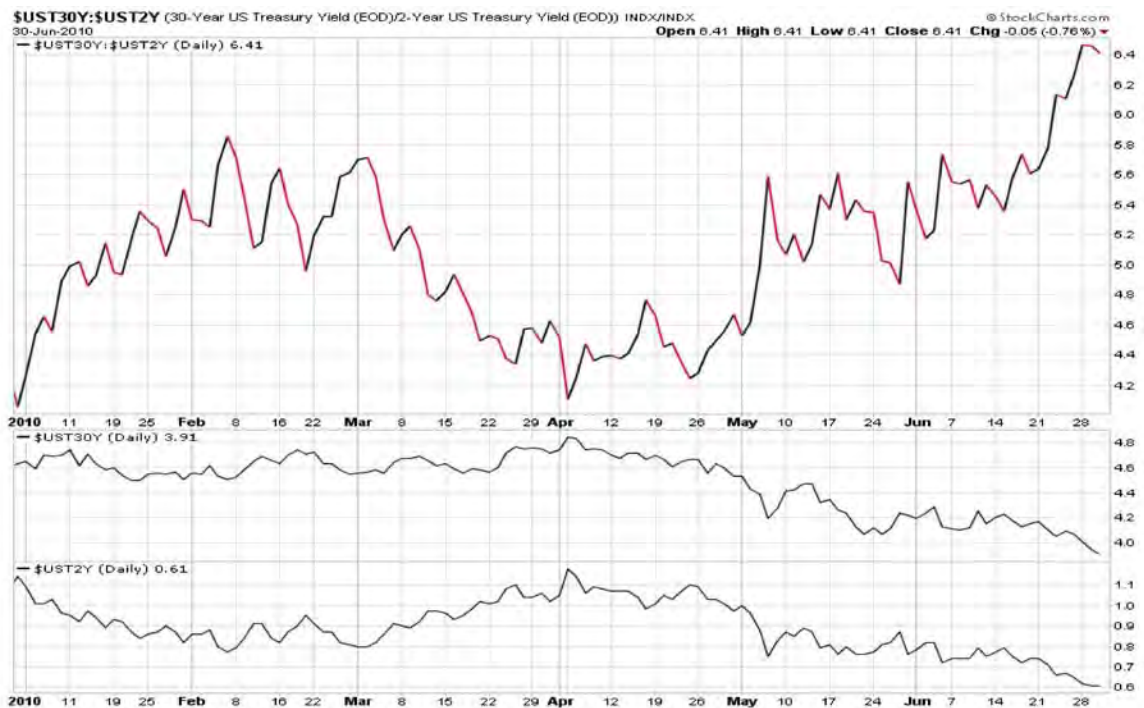
Money moves into US dollars, sending prices up....

Money moves into US bonds, sending yields down.





## Steep US Bond Yield Curve .



Last quarter, we discussed the equity market valuations raising concern that they may be fully valued based on the corporate earnings expectations and historical multiples. With expectations of muted economic growth (consensus for 2010/11 remains 2-2.5%), we considered the impact to current consensus estimates – were the analysts ahead of themselves once again?

At the mid-year juncture, equity markets are solidly in negative territory and bond markets have significantly outperformed equities. This seemed to give credence to our contention that equity markets may have lost their luster...at least for the moment.

However, the European debt crisis that reached a crescendo this quarter can be held accountable for the languishing equity prices. As sovereign default risk in Europe rose, and yields in the Southern European countries rose to near panic levels, the cost associated

with buying US dollars for European banks skyrocketed, and increased US bond buying forced yields down while the yield curve steepened considerably (see chart right). Two year US Treasury yields (bottom brown line) fell below 1% while the thirty year Treasury yields fell below 4%.

According to the International Monetary Fund, cross-border lending by European banks into Asia is more than a half a trillion dollars. With costs of borrowing US dollars rising, funding to Asia is becoming more elusive and the costs more dear. This is creating the expectation that economic growth in Asia will slow in the coming months. Of course we know that North American equity markets are fixated on Asian growth. The growing risk of an economic slowdown in Asia is directly correlated to lower global growth expectations in our capital-constrained world. For example, China imports of coal and iron ore fell by

9% and 8% respectively (as reported in the Economist) which suggests weakening demand. Slower growth expectations will result in lower equity and commodity prices.

At the moment, we continue to view markets with some skepticism until more evidence of economic strength begins to work its way into the system. Over the next couple of years we expect equities to provide better returns than bonds – but in the current noisy environment, we prefer to maintain a neutral position until better conditions unfold. While there are many problems currently facing the economy and stock market, this scenario is typical for the early stage of an economic expansion. Difficult problems are not easily resolved and there is usually fear that the economy will slip back into a recession. In addition, it is likely that market volatility will remain high in the short-term, pending the resolution of current concerns.





## Equity Markets

As mentioned earlier, equity markets were driven lower in the quarter as expectations of slower economic growth adjusted earnings forecasts downward. For Canadian investors, the S&P/TSX Composite lost 5.5% over the past three months pulling the year-to-date total return to -2.6%. In the US, the S&P500 return for the quarter was -11.3% USD, or -7.5% CAD. International stocks, as represented by the MSCI EAFE Index fell -13.8% in local dollars, or -9.9% CAD.

TSX Index



SP500 Index (USD)



MSCI EAFE Index



The Canadian market was artificially propped up by the materials sector, which represents almost 20% of the index and outperformed the overall index by 6.3% in the quarter. Also helping was the Energy sector, which outperformed the overall index by just under 1%. These two sectors make up over 45% of the index weight. Working against these relatively positive returns was the financial sector, with a return of -9.8% (almost twice the loss of the overall index). While Canadian banks were hurt with the credit crisis in Europe (down -8.7% for the quarter), insurance companies in aggregate fell more than 17% in the

past three months, led by Manulife stock which was down -23.7%. In the US, energy companies fell 12.7%, surrounding the BP problems in the Gulf, and the materials sector, which is largely comprised chemical companies, fell 15.3%. But these sectors only represent 15% of the S&P500 index (unlike the equity market in Canada). The big sector weights – Financials and Technology – fell -13.3% and -12.4% respectively on credit crisis and economic growth concerns (all returns in USD).

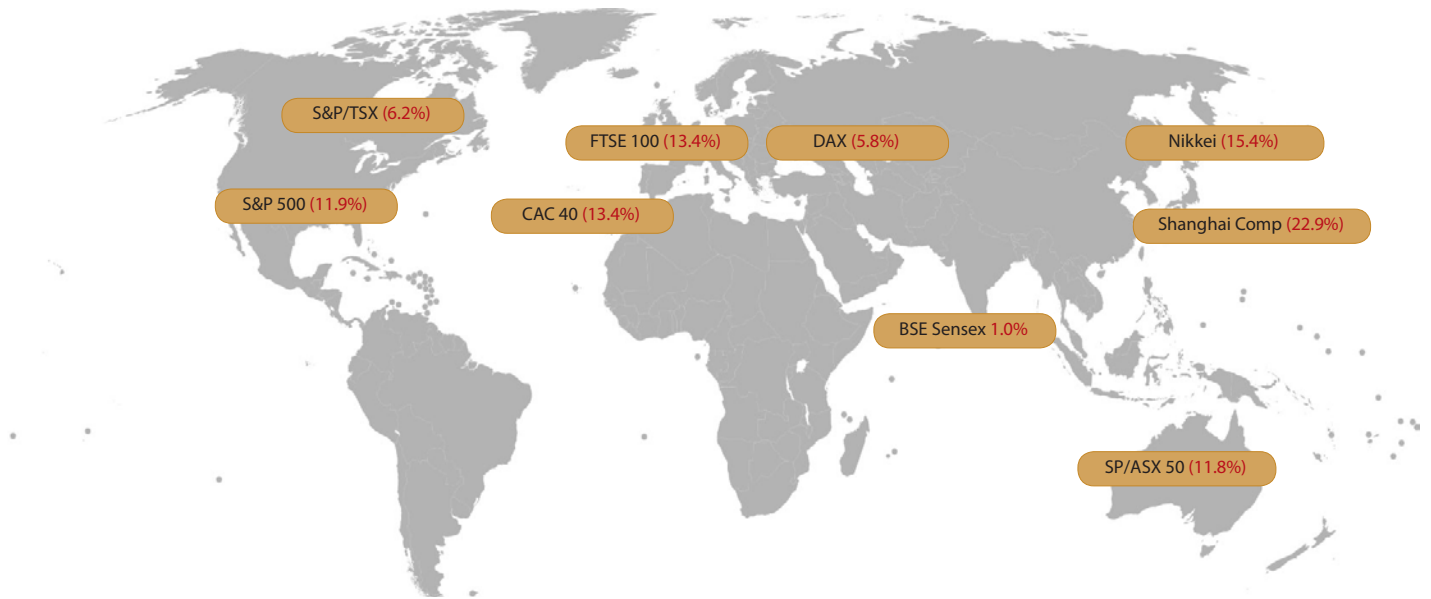
Overseas, China's Shanghai Composite fell 22.8% and Japan's

Nikkei fell 15.4% on predictions of slowing domestic growth, and shocks of the credit crisis in Europe opened questions around loan liquidity. In Europe, the MSCI Europe Index fell -16.4% even though the big three – German DAX, London FTSE, and France CAC, fell -5.8%, -13.4%, and -13.4% respectively (all returns in local dollars). We do not track the smaller individual European markets however some indication of the price weakness in small markets is indicated by the iShares Spain Index which fell over 25% for the quarter (USD).





GLOBAL EQUITY MARKET PERFORMANCE (Price Only)  
Second Quarter 2010 - in Local Currency



Finally, one of the few markets that added value in the second quarter was India. To date, expectations of continued economic growth abound as the economy expanded 8.6% in the first quarter (annualized). Two previous stimulus packages providing tax cuts and increased infrastructure spending in connection with lower interest

rates have significantly supported domestic demand.

As we move toward the final six months of the year, we continue to expect global equity markets to be volatile and filled with unexpected surprise – both positive and negative. The significant rebound in corporate earnings over the past year has run its course, and further

gains are largely dependent on economic growth. While we tend to agree with the consensus view that a “double dip” recession is unlikely, indications are that global growth is slowing. As mentioned in our last report, at current valuations, markets will require earnings growth to push equity prices higher.

## The Bond Market

The Canadian bond market enjoyed robust returns in June, as the European sovereign debt crisis, fears of an economic double dip in the United States, and equity market volatility prompted investors to flee to the safety of bonds. The DEX Universe Bond index earned 1.80% in the month, which compared favourably with the various losses in the equity market. The rally in Canadian bond prices and consequent

fall in yields occurred even as the Bank of Canada raised short term interest rates in June, and then recently again in July. Overnight rates now sit at 0.75% versus 0.25% on June 1st.

Canadian investment dealers reported significant buying of Canadian bonds by foreign investors during June. Some of the foreign buyers were apparently central banks looking to diversify their foreign currency reserves away from the traditional reserve currencies

such as the U.S. dollar and the Euro. International institutional investors and large hedge funds, though, were also buyers of Canadian bonds.

The sovereign debt crisis, which focused on the potential difficulties that certain European countries such as Greece and Spain would face in rolling over large amounts of maturing debt this year, prodded a number of other European countries to address their large fiscal deficits. By introducing spending cuts





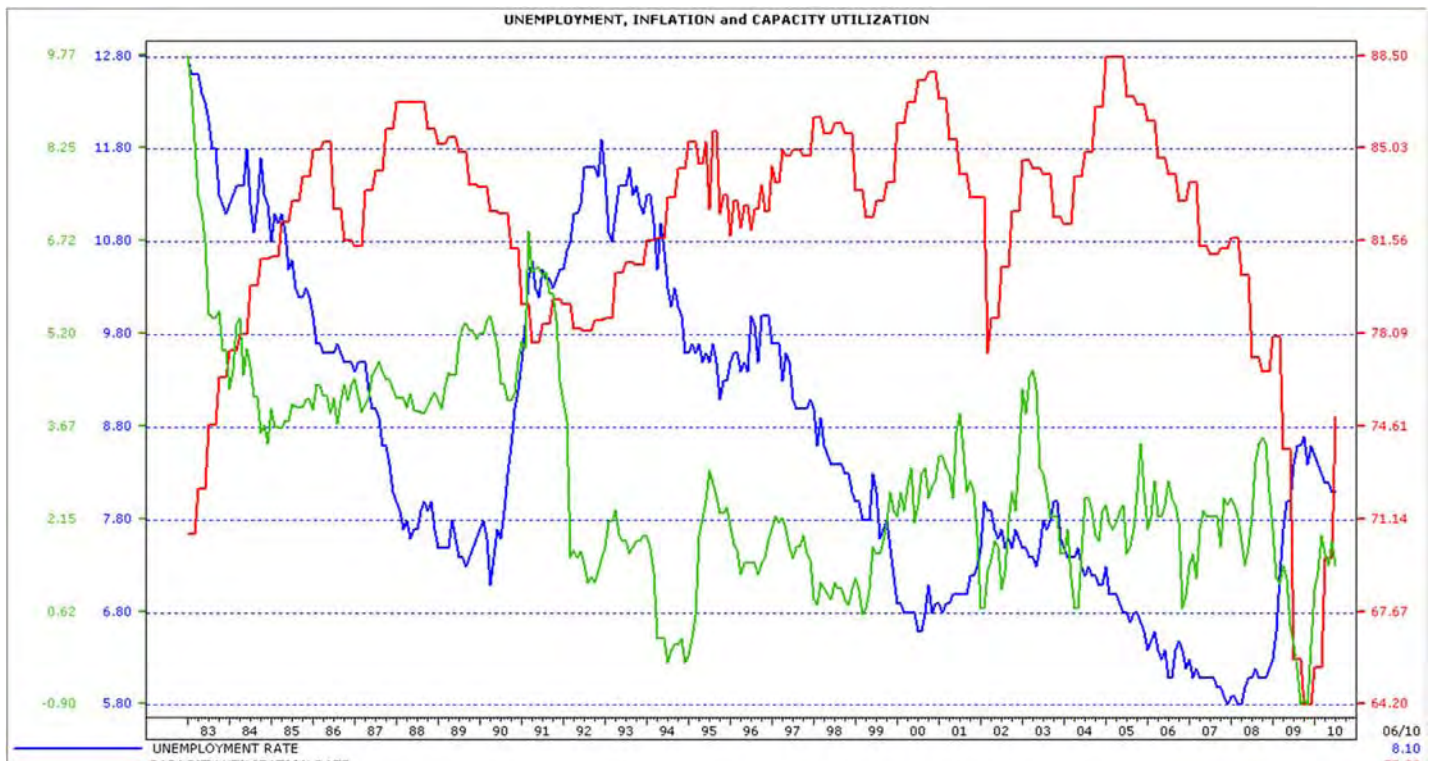
and higher taxes to sharply reduce their budgetary shortfalls, these countries, which included the U.K. and France, hoped to avoid similar financing difficulties. The new austerity measures, however, will reduce economic growth in the medium term, and that led to concerns about slower economic growth globally.

In the United States, economic data was mixed. On the positive side, recent industrial production numbers jumped 1.2%, contributing to a sharp 1.6% rise in the rate of capacity utilization. In

addition, consumer confidence was at or near 2-year highs. On the weaker side, new home sales plummeted 33% following the end of the tax credit for first time buyers, and starts of new homes fell 10% from already depressed levels. Retail sales declined in part due to the cessation of government incentives to purchase energy-saving appliances. The labour market remained weak, as weekly claims for unemployment benefits failed to shrink from their elevated levels. As this is being written, it has been revealed that the number

of jobs declined 125,000 in June, as the federal government laid off 225,000 temporary census workers. The U.S. unemployment rate did decline, however to 9.5% from 9.7% a month earlier.

Fears that the U.S. economy will fall back into recession seem unfounded. The “double dip” fears appear to be based on disappointment that the recovery was not more rapid, as well as concerns about the future pace of growth slowing as government stimulus programs are wound down..



In Canada, economic data was also mixed. While the unemployment rate remained at 8.1%, there was good growth in the number of jobs and in the quality of jobs (i.e. more full time and employer-based, and less part time and self-employed). Capacity utilization

in the most recent quarter jumped to 74.2% from 71.3% three months earlier, as manufacturing and mining showed particular improvement. On the weaker side, housing starts fell 6.3% due to stricter mortgage lending rules and retail sales declined on disappointing

car purchases. In addition, Canadian GDP was unchanged in April, following seven consecutive months of growth.

The flight-to-safety bid for Canadian bonds was most pronounced in shorter term issues. Yields on 2 and 5-year bonds dropped 46 and 43 basis



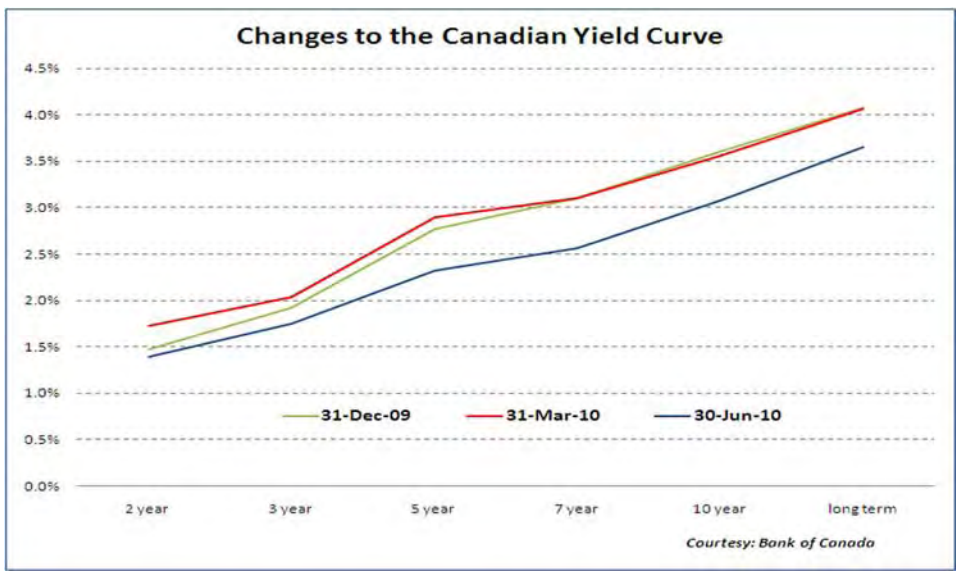


points, respectively, while 10 and 30-year benchmark yields declined 29 and 9 basis points, respectively. In part, the more pronounced declines in shorter term yields reflected greater demand by foreign investors for those maturities. The moves in shorter term yields were also influenced by domestic investors revising their expectations of the pace of future Bank of Canada rate increases. Slower growth in the United States and globally might negatively impact Canadian economic growth, which would reduce the need for the Bank to

tighten monetary policy. Indeed, statements in the second half of the month from Bank of Canada officials with regard to slowing global growth reinforced the possibility of the Bank pausing. The potential for slower increases in money market yields meant that shorter term bonds became relatively more attractive and investors bid up their prices, thereby reducing their yields.

Looking ahead, we believe the Bank of Canada will likely continue to raise rates by 0.25% on most of the remaining Fixed Announcement Dates this

year. Accordingly, the current level of benchmark Canada bond yields appears too low. Notwithstanding the steepening of the yield curve that occurred in June, we believe that the longer term outlook is for short term yields to rise faster than longer term ones. We remain positive with regard to corporate bonds, because of the historically large yield pickup relative to Canada bonds, their absolute yields, and the current growth stage of the economic cycle.



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