Compass

HIGHVIEW FINANCIAL GROUP™

Facilitating Excellence in the Management of Wealth

Winter/Spring 2011

What a difference two years makes. In early March of 2009 the credit crisis was in full swing and global stock markets were down roughly 50% or more from their pre-crisis peaks. In the Financial Post on March 7, 2009 the headlines were dire, screaming; *"U.S. Employment Index Decline Fastest in 35 Years", "Economy Has Fallen Off A Cliff", "New Home Construction Plummets", "Loonie Hits 4 ½ Year Low (at 76.89)".* It certainly was not a time that many felt confident about investing. In hindsight however, March 9, 2009 turned out to be the low point for many stock markets. Since that time most stock markets have staged a very impressive rally. The S&P 500 is up approximately 90% off of its lows and the S&P/TSX Composite index has risen just over 80%.

During this two year run there have been a few minor pull-backs, in the 10% range or less, but seemingly nothing can stop this stock market recovery. Not the threat of sovereign debt defaults in Europe, not a 200% increase in Oil prices, not the 30% rise in the Canadian Dollar, not the continuation of the U.S. housing crisis, not the relatively anemic economic recovery in many developed countries, not the upheaval in the Middle East and North Africa, not rising inflation in many countries, not even the devastating earthquake and threat of nuclear catastrophe in Japan (the world's 3rd largest economy). So why do the stock markets seemingly ignore the many risks that threaten the global economic recovery?

Many sound theories have been postulated including; the excess liquidity that is being pumped into the global economies by Central Bankers around the world, very low interest rates pushing investors out of bonds and into stocks in search of better returns on their cash, and a broad increase in the appetite for risk in an effort to accelerate the recovery of losses sustained during the market crash. However, one factor that can't be ignored is the tremendous rebound in corporate earnings. Since bottoming in March of 2009, trailing 12 month earnings on all stocks in the S&P 500 index have risen over 850% to the end of 2010[1]. However, even with this tremendous recovery in earnings, they remain roughly 5% below their pre-crisis peak, while the index itself is a little less than 10% below its pre-crisis peak. Even with the U.S. economy staging a relatively weak economic rebound, and with unemployment stuck at a lofty 9%, corporate American has done a tremendous job of cutting costs (which is partially responsible for the high unemployment rate) and boosting earnings. And this type of earnings recovery is similar to what has taken place in many countries around the world, including Canada which has been driven by strong earnings in the heavily weighted energy and materials sectors.

Typically a major component of the value of any given company is the present value of the future stream of earnings that it is expected to generate and the multiple that investors are willing to pay for those future earnings. So the question becomes, where are corporate earnings heading in the future, and what events could take place that might cause an adjustment to the multiple investors are willing to pay for future earnings? For answers to this one must consider a multitude of factors taking place in the global economies.

[1] *S&P 500 earnings for Q4 2010 remain an estimate as not all companies have yet reported.*

In our Spring 2010 issue of Compass we identified four ***key signposts*** to keep an eye on in an effort to gain some insight into the longer term trends that are likely to have an impact on global capital markets. Those signposts are; the exit strategies (of extraordinary stimulus) that Central Bankers telegraph to the market, effectiveness and aggressiveness of dealing with troubled financial institutions globally, deleveraging by the consumer in developed markets (as well as the state of the housing market), and the money multiplier.

Central Bankers' Exit Strategies

As the financial crisis gained steam in late 2008, Central Bankers acted very quickly in an effort to prevent a very severe and protracted recession from taking hold. In many respects they have been successful. Most economies appear to have turned the corner; albeit with varying degrees of success (see figures 1 and 2).

To accomplish this they slashed interest rates dramatically (to near zero in many countries) and flooded the market with liquidity. These measures were intended to boost borrowing and increase spending. However, the major risk with these extraordinary measures is severe inflation and over-heating economies. As a result, the effective removal of such stimulus is critical. Central Bankers around the globe are walking a fine line between leaving the stimulus in place too long, which can cause overheating economies and very high inflation, and removing the stimulus too soon which could drive their economy back into recession.

Figure 1

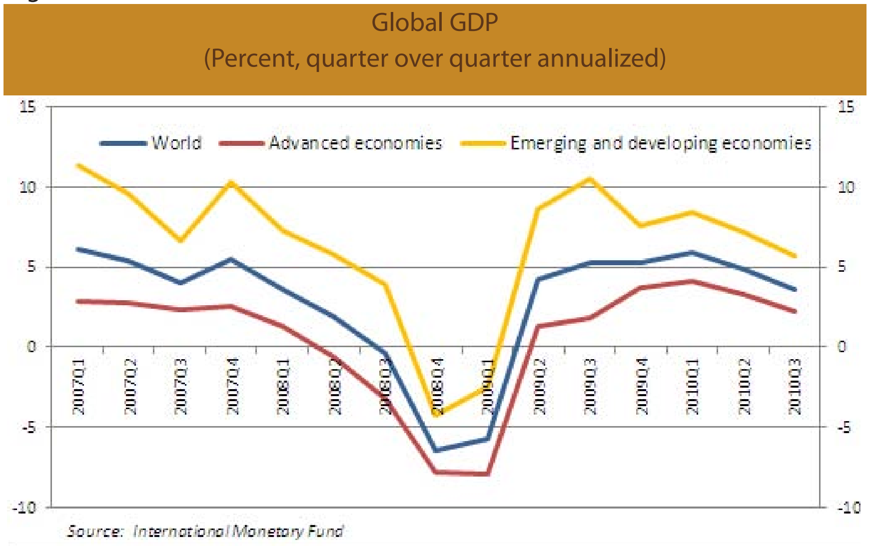
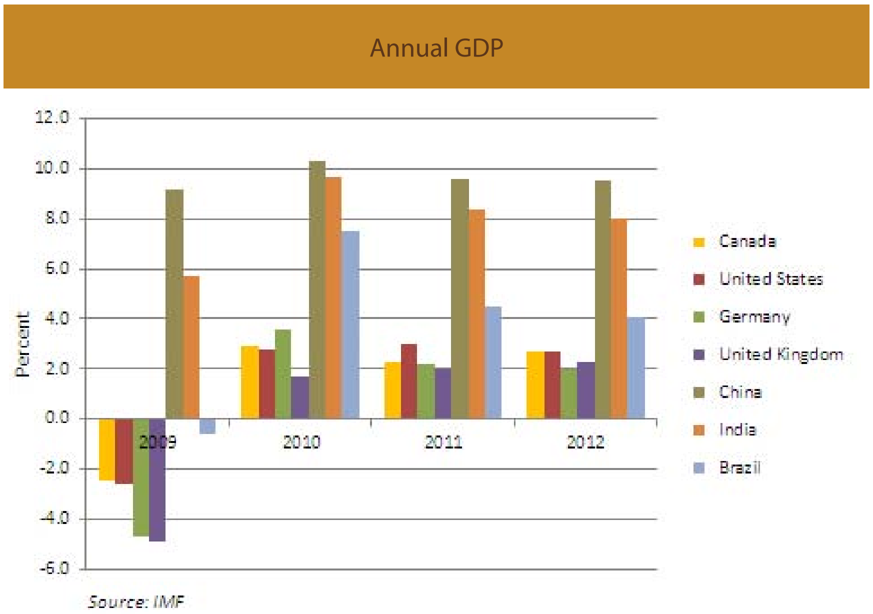


Figure 2



As the economy has gained considerable steam in China (surpassing Japan to become the world's second largest economy) the Central Bank there has raised interest rates 3 times since October of last year. In addition, the reserve requirement ratio for state-controlled banks has been raised seven times since early 2010, in an effort to reduce the amount of funds they can lend. As would be expected with an economy that is growing at over 10% per year, and a real estate market that has risen dramatically, inflation is beginning to take hold. At the end of December, inflation in China was running at an annual rate of 4.6%, which is well above the 3% target level. Only time will tell if the Central Bank's actions have happened quickly enough and have been dramatic enough to cool the economy (and inflation).

In the U.S., the Central Bank has made it very clear that they are focused on maintaining their stimulative actions for as long as it takes to get the economy into a position of a self-sustaining recovery. To date, they have expressed little fear of inflation. In his testimony to Congress on March 1, 2011 Ben Bernanke (Federal Reserve Chairman) acknowledged that if higher prices persist, inflation could become a serious risk, stating *"sustained rises in the prices of oil or other commodities would represent a threat both to economic growth and to overall price stability."* Since launching QE2 (i.e. second round of quantitative easing), which is intended to boost business activity and consumer spending by keeping interest rates low and injecting up to $75 billion into the economy, the Fed has come under much criticism by those who believe these actions will result in longer term inflation. To date, the Fed remains committed to their strategy and have made it very clear that they are confident they have the tools at their disposal to ensure a *"smooth and effective exit at the appropriate time."* While the threat of inflation is real, to date actual inflation has not become an issue in the U.S. (see Figure 3) and the 10-year implied inflation rate (see Figure 4) is also suggesting that inflation will remain subdued.

Figure 3

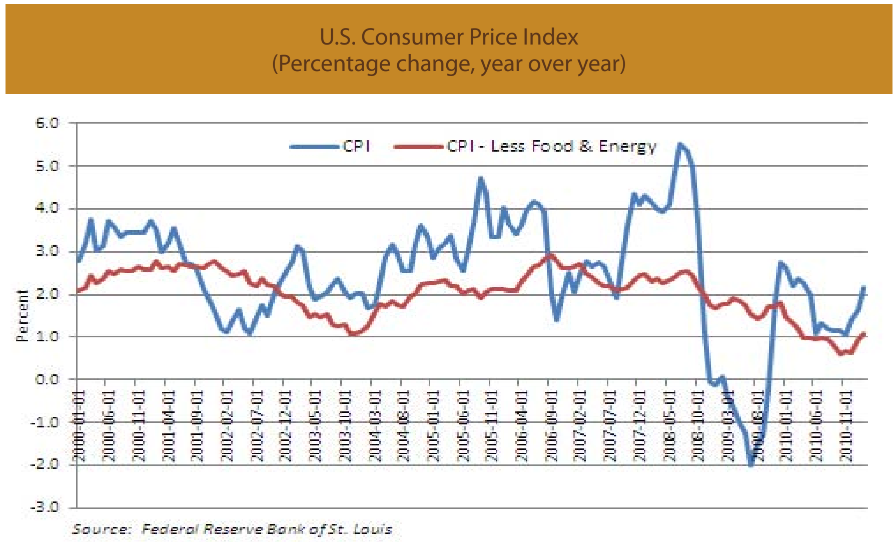
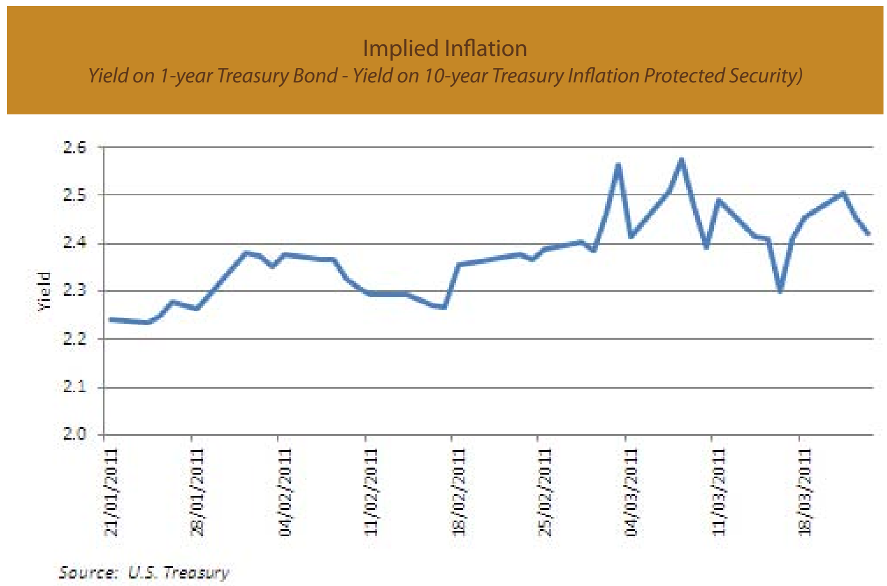


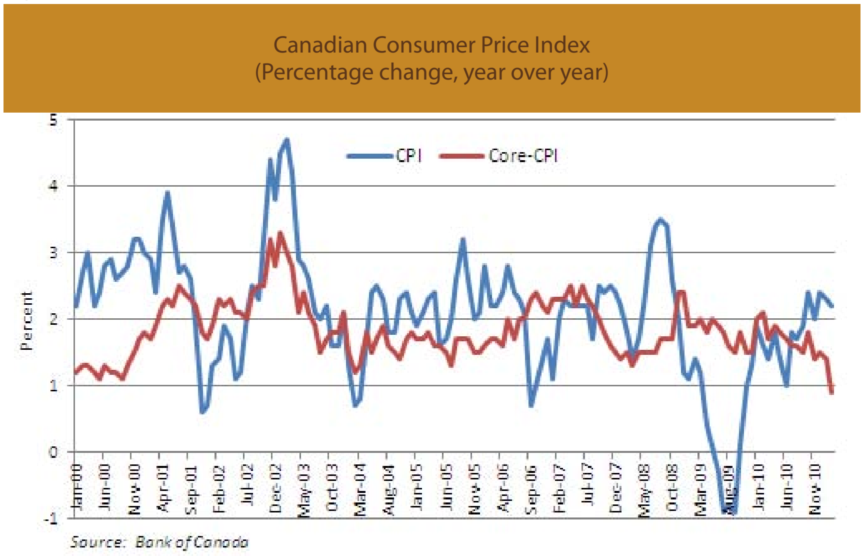
Figure 4



The Bank of Canada (BOC), on the other hand, has already begun to tighten by increasing the target overnight rate three times in 2010 (June, July and September) from 0.25% to the current 1% level. They have also sent very clear signals that rates will likely rise again this year, although they have acknowledged that exports have been weaker than expected (as a result of the strong Canadian dollar). Inflation in Canada, currently about 2.2%, does not appear to be a near-term concern (see Figure 5 on the following page).

As it stands, Central Banks have done a very good job of reflating economies around the globe. However, we continue to monitor both their words and their actions closely to gauge how the ongoing economic recovery is progressing.

Figure 5



Troubled Financial Institutions

As we all recall vividly, it was the financial institutions that brought many countries to their knees just 2 ½ years ago. Since that time, many efforts have been made to understand exactly what happened and how to prevent such a crisis from occurring in the future. While most countries have taken a close look at their bank regulations and made adjustments, it is really the new rules detailed in Basel III that will likely have the largest impact on banks going forward. Basel III is a new set of global regulatory standards on bank capital adequacy and liquidity agreed to by the members of the Basel Committee on Banking Supervision. This committee has members from 27 different countries and reports to the central bank Governors and Heads of Supervision of its member countries. The third of the Basel Accords was developed in a response to the deficiencies in financial regulation revealed by the Global Financial Crisis. These new regulations will be phased-in over the coming 8 years.

The tighter regulatory standards and new methods for calculating capital adequacy, on the surface, appear to be very positive, but effective enforcement will be the key.

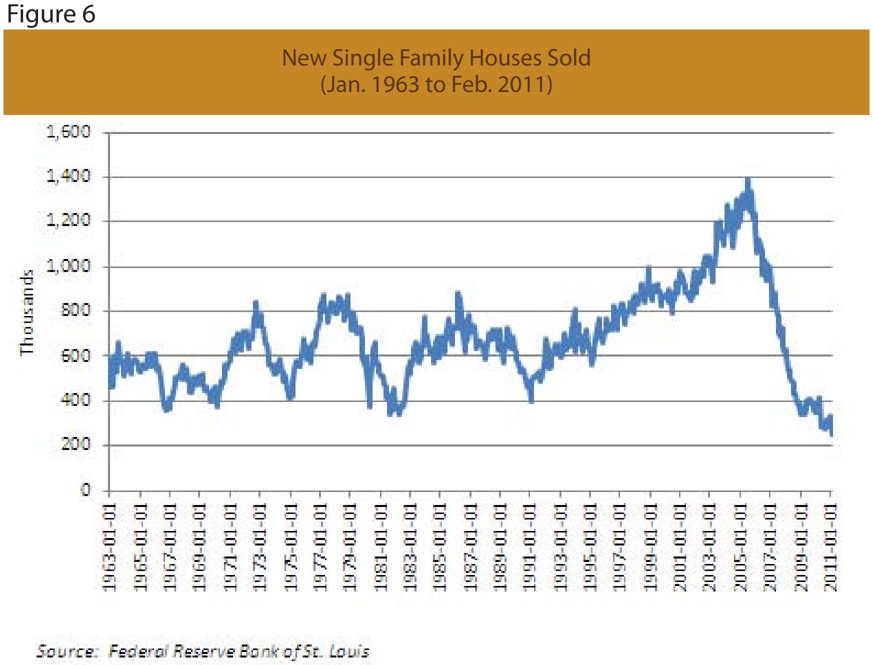
Further thoughts on the implications of these new regulations will be discussed in a future issue of Compass.

Our remaining two signposts (deleveraging by the consumer in developed markets (as well as the state of the housing market), and the money multiplier) will be explored in more detail in our next edition of Compass. However, some thoughts on the U.S. housing market are warranted at this time.

Since peaking in 2006, the U.S. housing market has staged a dramatic fall. Currently 18.4 million homes (11% of the total housing stock) in the U.S. sit vacant! 3 million foreclosures expected in 2011. New home sales continue to drop to the lowest rate on record (see Figure 6).

With the significant overhang of unsold homes, this problem does not appear to be turning around any time soon. This has a negative impact on the economy, from construction jobs to furniture stores. And with approximately 23% of mortgagees having negative equity in their homes, this impacts both consumer sentiment as well as consumer spending. Without the housing market at least stabilizing it is difficult to envision the U.S. economy strengthening substantially.

Figure 6



Our Outlook

Near Term: While we see inflationary pressures creeping into many markets around the world, we do not anticipate this will have a significant impact on most developed economies in the near term. Typically stocks benefit from modest levels of inflation as price to earnings multiples are higher than in times of significant inflation or deflation. The higher levels of inflation (and expected inflation) in developing economies is a concern and perhaps one of justifications for the lower price-to-earnings multiples in many of these markets (relative to those in developed markets). Further, modest inflation in the short term in Canada should prevent bond yields from rising significantly.

Longer Term: Generally speaking Central Bankers have been successful in their efforts to get global economies moving. Much work needs to be done in most developed countries to ensure the recovery becomes self-sustaining. Longer term both inflation and Government debt levels remain a significant concern. Central Bankers need to remain vigilant and be adept at removing stimulus before it is too late. Also, Government debt levels in many parts of Europe, the U.K. and the U.S. need to be addressed aggressively. If the debt and deficit challenges are not addressed effectively the market will force action by driving up interest rates which will have very negative economic consequences.

Implications For Client Portfolios

Given our outlook, we've highlighted below the core implications for our clients' portfolios:

» ***Fixed Income:*** Stick with Canadian dollar denominated bonds. As Canada does not suffer from many of the challenges of other nations, such as rising levels of inflation and exceedingly high levels of Government deficits, we do not believe interest rates in Canada will be rising dramatically in the foreseeable future. Our bond managers do believe that rates (and therefore bond yields) will be rising modestly over the next few years. However they do not feel that the "Bond Armageddon" that is forecasted by some is in the cards. Also, the manner in which the bond portfolios have been structured for our clients reduce the risk to investors should rates rise dramatically.

» ***Equities:*** Our equity managers state that they continue to find reasonable valuations for many of the companies they seek. We have also witnessed some recent buying by our managers, who had built up a little cash through the fall, as equity markets pulled back after the tragic events in Japan. As most of our equity managers (intentionally) have a distinct bias towards purchasing companies with relatively low levels of debt, which produce substantial and growing free cash-flow and tend to pay attractive and rising dividends, both our managers and HighView feel these portfolios are well positioned to whether a pull back in the markets which is bound to happen at some point in the not-too-distant future.

» ***No Change To Investment Managers:*** We have recently reviewed the outlook of each of the managers that we have engaged on behalf of our clients and are comfortable that they are well-positioned to succeed in the environment we envision. We remain confident that our managers will perform well in the current economic environment, but as always we will be monitoring their actions closely as well as the key signposts identified above.

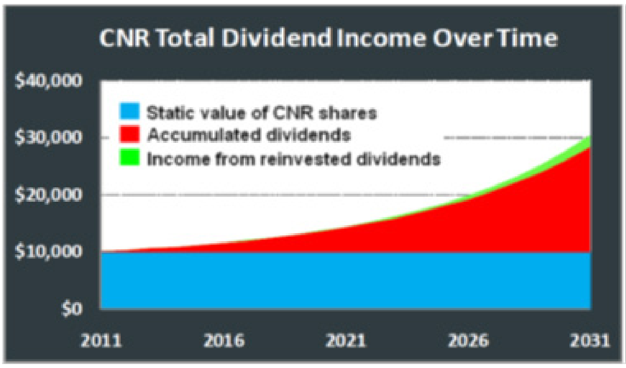
On the following page we introduce a new section to this report, "Manager Perspectives". This space is dedicated to sharing insights from our managers. In this issue we highlight a recent commentary from Dixon Mitchell. Dixon Mitchell Investment Counsel is a boutique Investment Counselling firm located in Vancouver. This particular commentary highlights the importance of dividends, and the benefits that a growing stream of dividends can provide investors over time.

Manager Perspectives

DIVIDEND GROWTH – Driving both investment income and total return

By: Dixon Mitchell Investment Counsel

In late January, CN Rail reported a 19% jump in fourth quarter operating income and announced that it will boost its dividend by 20%. With this increase, the compound annual dividend growth rate for CN Rail has exceeded 16% since it went public in 1996. Dividend growth is an important attribute in our stock evaluation process, both because rising income helps to drive total return and because dividend increases often signal management's confidence in their company's ability to generate and grow cash flow in the future. Even though CN currently offers a modest yield of 2% and would not be considered an "income" stock per se, dividend growth will likely play an important role in the stock's future performance. Consider the following example: assume one invested $10,000 in CN Rail today and the company was able to keep raising its dividend at an annual rate of 13% (about one fifth less than its historic clip). Assume further that the price of CN stock never again rises from its current level, so that even 20 years from now, the original $10,000 investment is worth the same amount (the horizontal blue bar in the chart below). As time passes and CN pays out income at an ever increasing rate, the dividends collected would start to pile up, resulting in an accumulated $28,494 after two decades (the red wedge on the chart). If one was able to reinvest the dividends received so that these funds also produced future income, the final tally would be even higher at $30,645 (the green sliver). Based on this accumulation of capital, the compound annual return earned on CN shares over 20 years would be about 5.8% - again, that's assuming the share price never budged. If CN keeps boosting its dividend at the rate we've assumed, however, and its share price remains locked at today's level, the dividend yield on the stock after 20 years would exceed 23%. Unless we find ourselves in a 25% interest rate environment, the probability of this occurring is virtually nil. More realistically, CN Rail shares will appreciate alongside income growth, pushing total return nicely above the 5.8% earned from dividends alone.



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