MARKET UPDATE

Review of Events

Stock and Bond markets have continued to exhibit unusual volatility. This bear market saw its initial low in October of 2008 and the first rally in December ending at about 9,600 on the S&PTSX. The Toronto market declined from there into March where the index touched 7,479.96. The subsequent rebound has produced a gain of 41% from the low and an increase for the year of about 14% as opposed to yearly losses for the major American exchanges. Canadian stock market outperformance has been due to strength in commodities, especially energy, and financials.

My December letter questioned the strength of the US dollar and opined that the cause of this strength was probably due to nervous investors seeking safety by buying US Treasury securities and creating a bubble in this asset.

The US Treasury market is represented by the 20 - year bond Exchange Traded Fund. This ETF had risen from $93 to $121 during the sharp upward move in the US dollar. It has since made the round trip back to its present price of $91. The Canadian bond market, in contrast, has been very steady, both short and long. The US$ has weakened considerably against most major currencies including the Loonie.

Gold, which has been strong since November when it traded briefly at $700, has had a sharp move recently to the $930 level. It is starting to look “toppy”. There has been immense speculation in gold via ETF’s. The actual jewellery demand, which is the largest market for gold, has been very weak and the inflation rate is low so one would expect that speculation is carrying gold at the moment. Certainly the increase in gold invested in ETF’s would support that opinion.

State of the Economy

This week Scotia Bank declared the economy in recovery mode. The stock market is a leading indicator for economic activity and with the market being up over 40% a case can be made that we have begun a new bull market with a recovering economy soon to follow.

In my opinion, not only are the conditions not in place for an economic recovery but there is no sense that the preconditions are present. This recession is different because almost all sectors of the economy must deleverage – reduce debt.

The latest stock market advance has seen some of the largest gains in the banking sector. Yet that sector is most compromised due to real estate obligations, including corporate real estate where risk is starting to rise. Default rates in consumer credit card debt are starting to climb as well.

In previous recessions, as downturns occurred, management was quick to reduce labour costs by laying off staff. One of the features of the economy prior to this downturn, however, was the shortage of labour. Thus there has been a reluctance to shed workers in this downturn. And there have been innovative staffing techniques including work sharing, unpaid leave and other acts which reduce payroll costs but retain staff for an improving economy. When management comes to believe that the economic downturn will be longer than they first imagined and cut deeper than they anticipated, the unemployment rate will increase as workers are let go.

Debt levels by national governments are increasing to worrisome levels. It is estimated, for example, that the increase in American government debt this year will be 1.75 trillion dollars. While this is the most egregious increase, TD Bank has given warnings that the Canadian government is setting the stage for a difficult debt recovery problem.

There is general agreement that nations must cooperate to overcome this economic downturn which has extended its reach worldwide. The initial actions by international summits were positive. Most recently, we find evidence that there are discriminatory actions by countries in which beggar thy neighbor attitudes are emerging. These will not be allowed to go unchallenged.

Interest rates are as low as they can go. Unemployment will likely rise. Debt levels are still too high. Credit problems have not been solved. Tension is evident in international trade. That does not sound, to me, like the economy has turned the corner.

Investment Outlook

I continue to believe that we are presently witnessing a bear market rally and can expect a fairly large retracement of the recent move from 7,500 to the present 10,500. Cash continues to be a very important and a large component of all portfolios due to the uncertainty of government action.

It is very likely that the economic recovery will be very slow, price to earnings ratios will be lower than the average 14 to 16 times and dividends will represent a good portion of the income derived from equities. If this is so, then both speculation and volatility may be reduced.

My comfort zone will be reached when volatility is muted. This past week was the initial convertible debenture offering that I expect to become quite common. It was issued by Goldcorp and was oversubscribed.

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