CANACCORD Genuity
Wealth Management

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GROUP

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Bad News For Bond Investors!

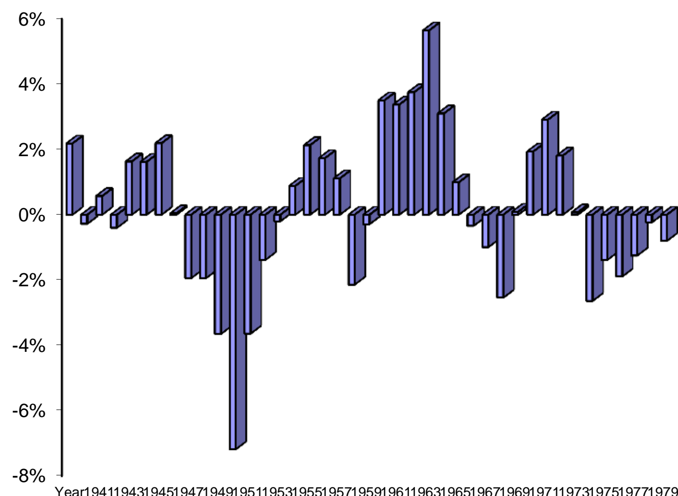
Five-year US treasury bonds recently hit an all-time low of just 1.4%; and the ten-year ones were not much better at 2.6%. Five and ten-year bonds in Canada yielded little more, at 2.1% and 2.9% respectively.

Investors have been rushing to bonds in fear that short term interest rates might stay at zero for the rest of their lives. Mutual Fund investors have been piling into bond funds in record numbers, hoping to increase yield while keeping their money “safe”, at the same time as bond speculators are hoping for yet lower yields if outright deflation takes place.

Over the past 30 years people could grow their net worth by staying in cash or government bonds. Now, with government and individual debt so high, cash and bond investors may lose relative to their purchasing power.

Consider the chart below which shows five-year investment periods from 1940 to 1980. Of these 40 years, 20 of them produced negative returns relative to their purchasing power. Note that the worst period for bonds was just after WWII when budget deficits had ballooned with the cost of the war.

<u>REAL INTEREST RATES FOR GOVERNMENT OF CANADA BONDS OVER 5 YEAR PERIODS</u>



I believe that at present the relation of risk to reward for government bonds is unfavourable. Since the purchase of a 10-year Canadian government bond with a yield of 2.9% might produce a sharp decline in price at some point in the future, the low yield doesn't compensate for one's risk.

Deflation is defined as "a fall in the general price level"[1]. Imagine your money gets more and more valuable. Doesn't sound too bad to me. Unfortunately, deflation encourages saving; in other words, discourages consumption. Since consumption produces 70% of economic output, governments would rather devalue your money to encourage spending. Current inflation rates in Canada, the US, and Europe are all above 1%, yet governments are acting as if we are in outright deflation. If inflation rates drop further, watch for more 'quantitative easing' by governments.

Quantitative easing is code for central banks printing more money. They do this by buying massive quantities of government bonds, and then paying for them with newly-created money. Inflation has always been a result of too much money creation, and that is what looks to be coming.

Unfortunately for investors holding cash, this does not mean that short term interest rates will go up anytime soon. While I have sold my US treasury bonds, I continue to hold high quality Canadian Preferred Shares which yield 5-6%. Moreover, the Canadian dividend-tax credit provides an interest yield equivalent of over 7%.

I continue to hold physical gold, but currently find better value in companies such as Barrick, Goldcorp, Agnico Eagle, or Yamana. Gold and gold stocks have also tended to perform well in the September to January period.

I would also suggest that investors consider another asset class: stocks. In the late 1990's and early 2000's I suggested that real-return bonds represented better value than stocks. At the time, real-return bonds yielded over 4% plus inflation, while stocks generally yielded just 1% to 2%. Now, however, real-return bonds yield just over 1%, while many blue chip stocks yield 3-6%.

Please keep in mind that I am far from bullish on the economy. In fact, though Canada's 1st quarter GDP grew at a breakneck 6.1%; it looks like the second quarter will be way down when the data is released. Furthermore, Canada's housing bubble is beginning to unwind. That being said, below I have constructed a 15 stock portfolio consisting of companies which have weathered the current "great recession." None of these companies have anything to do with housing; and many are multinationals which sell products all over the world, including faster growing economies. With interest rates where they are, stocks represent compelling value relative to government bonds. One measure of stock valuation is P/E, or price-to-earnings ratio. One of the most bearish economists, David Rosenberg, forecasts earnings for the S&P 500 (500 large US companies) of 75 for 2011. So the P/E of the market is currently 14.6 times earnings--

[1] www.dictionary.com

which compares favourably against the long-term average of 15. A P/E for ten-year government bonds would be 38; which means stocks are currently much cheaper than bonds.

This stock portfolio represents a multi-industry approach with a global perspective. At the time of writing (August 17th, 2010), the portfolio produces a dividend yield of over 4%, with a dividend growth-rate of over 7% per annum over the past five years. Also keep in mind that when inflation does return, companies can raise their prices to their customers to ensure themselves a level of inflation-protection.

CANADIAN EQUITIES

Company		Price	Dividend Yield	5-year dividend growth
TransCanada Corp.	(Pipeline)	$35.90	4.46%	25%
Shaw Communications Inc.	(Cable)	$20.86	4.22%	103%
Fortis Inc.	(Electric/Gas Utility)	$28.55	3.92%	75%

US EQUITIES

Company		Price	Dividend Yield	5-year dividend growth
Verizon Communications Inc.	(Telecom)	$29.96	6.34%	17%
Proctor and Gamble Co.	(Consumer Products)	$59.77	3.22%	55%
Johnson and Johnson	(Consumer Products/Pharmaceutical)	$58.01	3.72%	44%
The Coca Cola Co.	(Beverage)	$55.88	3.15%	42%
McDonald's Corporation	(Restaurant)	$71.79	3.06%	120%
Kraft Foods Inc.	(Food)	$29.45	3.94%	26%
General Mills Inc.	(Food)	$35.15	3.19%	60%
Waste Management Inc.	(Garbage Disposal)	$33.25	3.79%	43%
Raytheon Co.	(Defence)	$44.76	3.35%	56%

GLOBAL EQUITIES

Company		Price	Dividend Yield	5-year dividend growth
Sanofi-Aventis	(Pharmaceutical)	$28.75	5.10%	52%
Vodafone Group PLC	(Telecom)	$24.13	5.38%	8%
Unilever PLC	(Consumer Products)	$26.80	4.10%	58%
		Avg -	**4.06%**	**52.26%**

One word of caution. September/October have tended to be down months for the stock market, especially in mid-term election years, as now. Personally, I would say that the odds of a correction are only 50/50; so I have started buying, but will leave some cash on the sidelines in the event of a correction.

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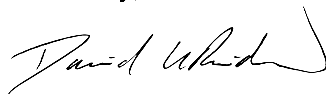
Sincerely,



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