

July 2013



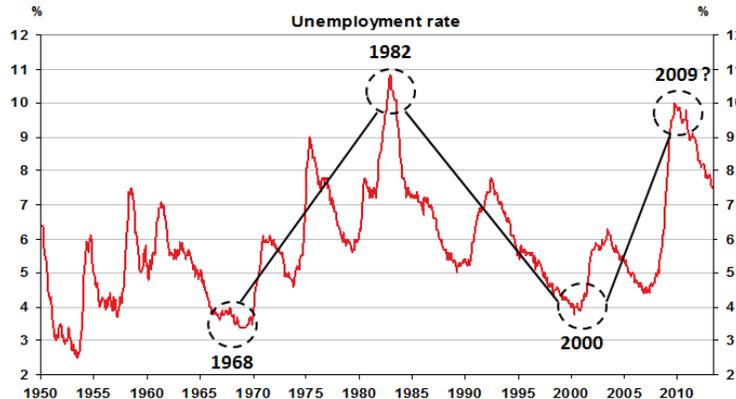
Investing, Like Golf, Can Be Counterintuitive

There's an old saying in golf which says, "swing easy and accept the extra yardage." Similarly, if you want to avoid a water hazard on one side of the fairway, make sure the clubhead swings towards the hazard. Perhaps this suggests why it's not so easy to be proficient in golf. The counterintuitive nature of investing is also why so few investors or investment professionals produce superior returns over time.

Consider the chart of the U.S. unemployment rate going back to 1950. In 1966, the U.S. unemployment rate fell to under 4%; yet the Dow Jones Industrial Average peaked along with the strong employment. In 2000, unemployment fell once again to 4%, which also corresponded to a stock market peak.



The unemployment rate down from a cycle peak



Source: Datastream

The 1982 and 2009 unemployment peaks of 11% and 10% respectively were certainly characterized by harsh economic conditions, yet both occasions represented excellent entry points into stocks. To quote the late, great investor, Sir John Templeton:

“People are always asking where is the outlook good, but that’s the wrong question, the right question is: where is the outlook most miserable.”

- Sir John Templeton, 1995

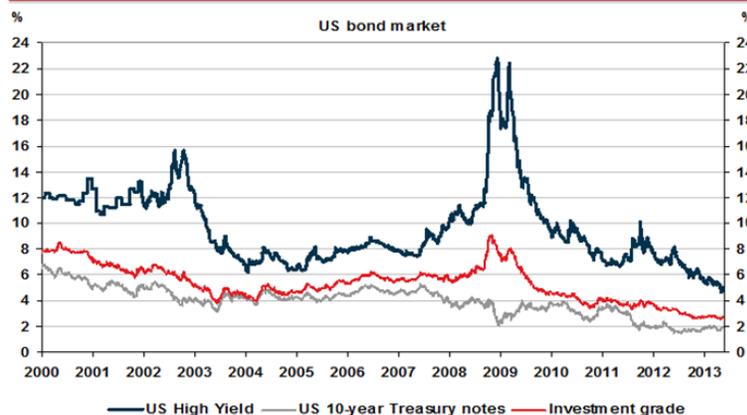
The object of the game when it comes to investing is to buy low and sell high; and one has the best opportunities to acquire bargains when, as Templeton says, “the outlook is most miserable.”

Many investors have in recent times been fearful of U.S. stocks because of the U.S. budget deficit. Remember 1999, when the U.S. ran a record budget surplus. In hindsight, that was a poor time to be entering the stock market; whereas the record deficit in 2009 represented an excellent entry point.

Such a counterintuitive tendency has likely caused an inflated level of bond prices today. After suffering two stock market declines (in 2001/02 and again in 2008) it seemed that investors had had enough with stocks. From 2007 to the present, they have poured \$1.3 trillion into bond funds, while pulling almost a half-trillion out of stock funds. After all, bonds were “doing well” and bank interest rates were next to nothing.



Bond yields at historical lows



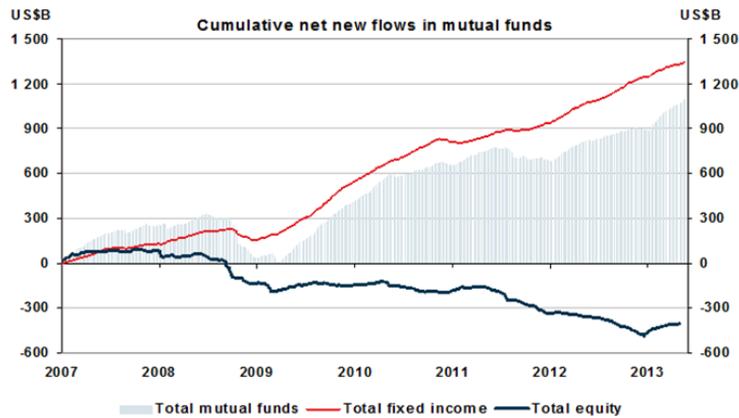
Source: Datastream

Bond prices are inversely correlated to interest rates. In other words, when rates are at their lowest, bond prices are at their highest. So it appears that the investing public may have marked the top again, except this time with bonds. Many bond fund investors have viewed the 1-year past return as the forward-looking return, but bond prices are mostly lower so far in 2013. It will be interesting to see how investors will react when they view their statements and see losses. The greatest risk in bonds may be in the high-yield category (formerly known

as junk bonds) where prices are at their highest value and the yield at the lowest level of just 4.7%. This is not very attractive, considering a historical default rate of 5.2%.



Massive inflows in bond funds since 2007

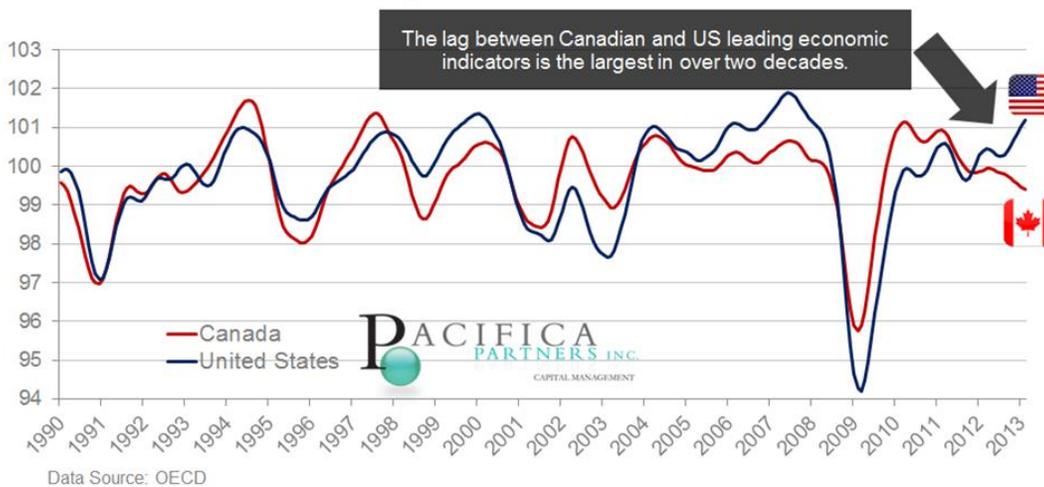


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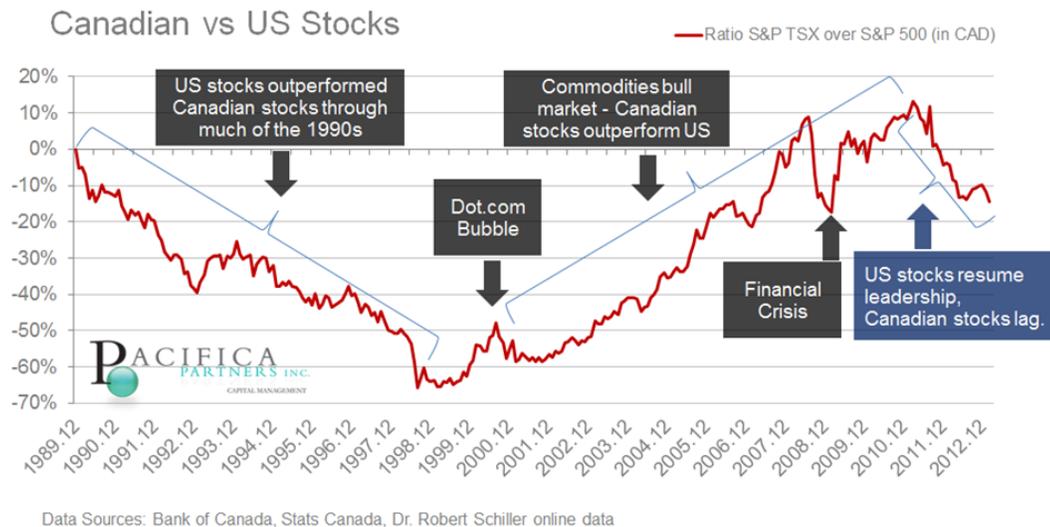
Investor intuition has also caused many investors to shun the U.S. equity market in favour of Canadian stocks. After all, Canada did not have a banking bail-out; real estate prices did not crash, as they had done in the U.S. and much of Europe; and the Federal budget deficit was amongst the lowest in the Western world. Why, then, has the Canadian stock market produced near zero returns year-to-date versus double-digit returns in the U.S.?

Canada and US Leading Indicators



Data Source: OECD

The preceding chart illustrates leading economic indicators since 1990. The chart shows that while the Canadian and U.S. markets behaved much alike, there has been a recent divergence, whereby U.S. leading indicators have improved and Canadian ones have deteriorated. Recent reports show strong employment numbers, but Canadian manufacturing shipments have receded to recession levels. Furthermore, housing activity has flatlined, or even deteriorated in some markets. In contrast, U.S. real estate activity has gone from extreme weakness to strong gains in most markets.



Valuations of equities are for the most part more attractive in U.S. stocks than in Canadian ones. For example, a recent stock offering of Enbridge common stock, which is a great company, was offered at 28 times earnings – U.S. utilities can be purchased for 30% less. Canadian bank shares have been flat this year, unlike the strong gains seen in U.S. banking shares. Canadian bank stocks trade at about 2 times book value; while U.S. bank shares trade at just about book value. Banks are still leveraged to real estate and U.S. real estate is recovering from a crash, while Canada's is vulnerable to a decline.

Finally, Canada has far more commodity exposure in the stock market; and with China's economy slowing and continued weakness in Europe, commodities have been declining.

Brace for choppy markets through the summer months but we intend to take advantage of opportunities as they arise.

Sincerely,

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