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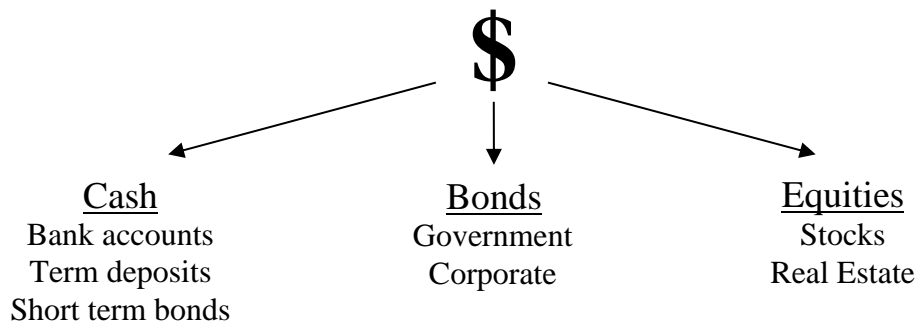
Stay One Step Ahead of the Crowd to Maximize Returns & Reduce Risk

A common misconception amongst investors is that only economic activity and corporate profits drive stock prices. In reality, it is actually the flow of money that moves the markets.

In the fall of 1987, stocks declined by over 30% in a very short period of time; yet, corporate profits were up 11% and would grow another 50% in 1988. By comparison, corporate profits increased by only 0.3% in 2012, while stocks gained 13.4%. In 2013, profits grew 11% and stocks surged higher.

To understand this apparent contradiction – why stocks are sometimes correlated to profit growth and other times completely unrelated – it is important to understand what drives the masses, and subsequently, capital flows.

Consider that every investor faces the following investment decision tree:



In 1987, when stocks fell 30% despite the growth in corporate profits, the U.S. 10-year Treasury bond yields rose from 7.08% in January to 9.52% by October, while the 30-day T-bill rates increased from 5.75% to 7.88%. Thus, it wasn't that the economic sky was falling, but rather that money was being pulled from stocks because the government guaranteed rates had become more attractive.

The opposite effect was in force in 2012, a year where Europe was mired in recession. Greece had defaulted on their bonds, and countries like Portugal and Spain had both come dangerously close to doing the same. In the U.S., corporate profits weren't growing, but U.S. stocks advanced. The reason boiled down to money flows. U.S. cash interest rates remained at zero, and U.S. 10-year bonds declined from 3.75% in January to a low of 1.7% by year-end. As such, capital continued to leave fixed-income in favour of stocks.

In 2013, cash yields remained near 0% and 10-year bonds climbed from 1.6% to a high of 3%. Although many investors started to feel more optimistic about the economic outlook, 0% and 3% returns were not enough to entice investors out of stocks and into cash or bonds.

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So - where does this leave us in 2014?

In the March 2012 "LePoidevin Letter," I talked about the "true value" of stocks: the earnings yield. Current profit forecast for the S&P 500 is \$122 of profits and the current index level is 1846.¹

$$\frac{122}{1846} = 6.6\% \text{ earnings yield}$$

Comparing the current 6.6% earnings yield of stocks to 0% in cash or 10-year bonds of 2.7% suggests that the money flow is likely to continue to move out of cash and into stocks.

While I talk about the masses moving money between asset classes, it's important to remember that, regardless of general trends, stocks can move on any given day based on factors like headlines or emotion. Despite the fact that stocks have advanced overall for the past couple of years, there have been almost as many down market days as up. Some investors have been scared off in these short-term down markets, and sold their equity positions in favour of cash. The problem for these investors is that cash currently offers a 0% return, causing most of them to return to the stock markets a short time after selling.

It is possible that in a recessionary period, people could flee stocks in favour of 0% cash. As we know, there have been times of panic where investors chose a 0% yield over losing their capital. However, there is little chance of a U.S. recession in 2014. Every single recession in U.S. history has been preceded by an inverted yield curve (when short-term interest rates exceed long-term rates) including 2000 and 2007. Currently, the yield curve has a steep positive slope, providing evidence that a recession is not on the short-term horizon.

One area of concern for the market in the coming weeks could be China. As I mentioned in the February 2011 "LePoidevin Letter," China has been super-charging its economy based

¹ Thomson ONE: SPX (S&P500 index) as of March 13, 2014

on credit. Since just 2008, the amount of credit extended in China is equivalent to all the credit extended in the entire United States!² At present, the West has begun to pull its capital, the Chinese currency is falling, and corporate bond markets seem to be unraveling. This could be problematic for Canada too, as a weakened Chinese economy will impact China's demand for commodities. Additionally, the Chinese have been pouring money into Vancouver and Toronto real estate. These markets could also be significantly impacted should the Chinese government reinstate capital controls, which is possible if the currency continues to decline.

Another area which we will be watching closely is inflation. While inflation rates have been near multi-year lows, there is mounting evidence – such as less slack in the labor markets – to suggest a change in the near future. For example, in the late 1970's, higher wages and increasing strike activity caused interest rates and inflation to rise drastically. A recent survey from the National Federation of Independent Business has shown that the inability to find workers has recently surged to multi-year highs, which could be an indication of an impending rise in inflation as the unemployment rate decreases.

When interest rates and inflation do eventually rise, it will be these higher rates that lure investors out of stocks. I will be keeping a close eye on inflation and interest rates in order to help determine the appropriate time to significantly reduce stock holdings.

Sincerely,



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² Prem Watsa Fairfax Holdings Investor Letter (March 2014, p.16)

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