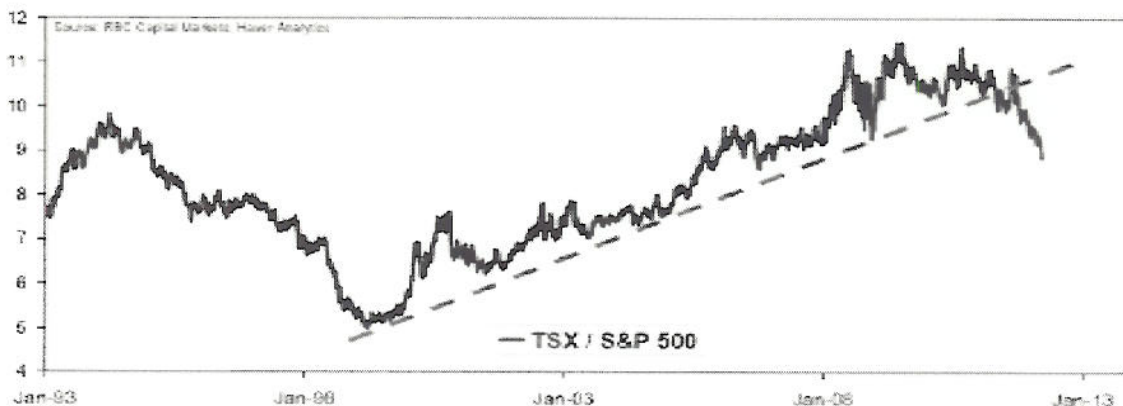


Monday, April 9, 2012

First Quarter 2012

The first quarter of 2012 was the best for global stocks in more than a decade (up 8.9%) with the notable exception of Canada (up 4.4%). The U.S. S&P 500, up 10.5% in Canadian dollars in the first quarter, continues to widen its gain on the Canadian S&P/TSX Composite, which now stretches to a whopping 22% advantage in favour of U.S. stocks over the last 12 months. This is a change. The TSX had outperformed in 8 of the last 10 years. The chart below of the TSX versus the S&P 500 illustrates the dramatic underperformance of the Canadian stock market in the last couple of years.

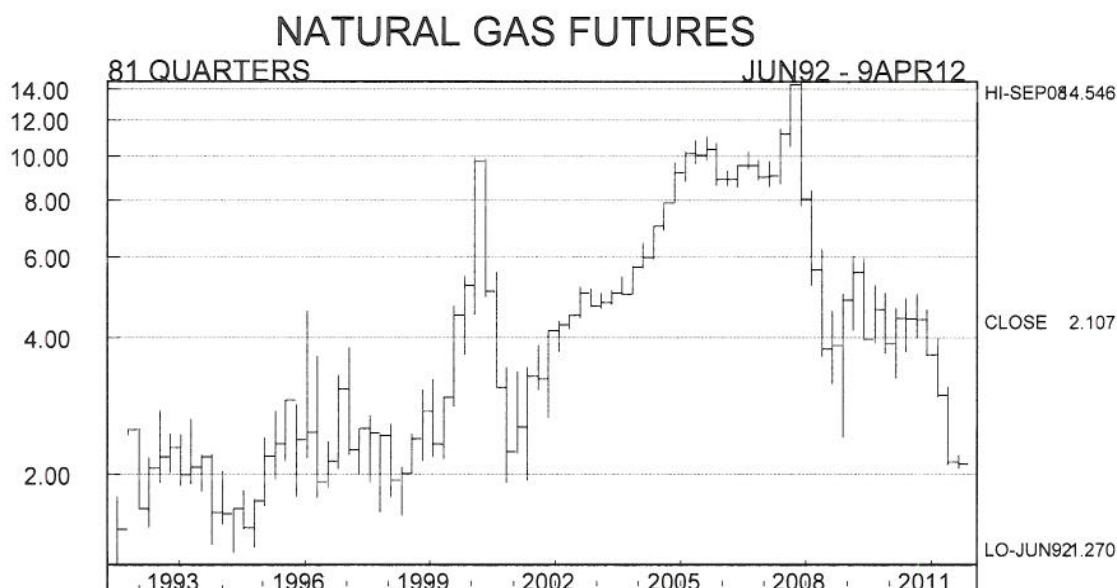


Source: RBC Capital Markets, April 9, 2012

Since last summer the global economy has been slowed by the European solvency crisis and by the Government of China's efforts to slow down their property boom. The Canadian stock market is 50% weighted in the economically-sensitive resource sectors, Energy and Materials, and commodity prices have been slipping for the past year.

It is too soon to declare that the cyclical global economic slowdown has ended the multi-year leadership of the TSX, of commodities and, of emerging markets. As RBC's Myles Zyblock writes (April 4, 2012), "China is a big deal. But, perhaps a lot of its influence has been paid for by the decade-long advance to 2008 (e.g. oil is up 15-fold, lead up 9-fold, and copper up 8-fold)." One might think that, in response to rising prices, eventually increasing supply of commodities would swamp demand. Regular readers will know I've been thinking that for 6 years or so.

The most spectacular example of falling commodity prices is the price of natural gas. With natural gas selling today for about \$2.06 per million British Thermal Units (BTUs), its equivalent price for the same energy as a barrel of oil would be \$12, or about 88% less than today's price of sweet crude of \$101.30 a barrel. The chart below shows the price of natural gas is back to where it was 20 years ago:



Source: RBC Trend & Cycle, April 10, 2012

Mild winter weather has been a factor. For the first time I think in my lifetime Lac St. Louis did not freeze over this winter. But weather aside, there is suddenly oodles of the stuff. In just 4 years the combination of two technological breakthroughs, the hydraulic fracturing of shale deposits and, horizontal drilling, has led to a profound change in the North American energy market, a 'real game changer'. Examples of US industries that will benefit from lower North American energy costs include manufacturers (especially chemicals), and pipelines. Industries dragged lower with the price of natural gas will include coal.

The increase in US shale natural gas will in the long term lower US manufacturing costs. Producers of fabricated steel, transportation equipment, machinery and chemicals use natural gas extensively. The increase in domestic natural gas liquids production makes a cheaper feedstock for US petrochemical companies, including a science and technology company like DuPont.

Pipelines, of which we own a variety, are the most efficient way to transport natural gas. Shale plays add to volume growth and create a need for investment to expand pipeline capacity.

It has become cleaner and arguably cheaper to make electricity from natural gas than coal. American railroads are transporting less thermal coal (U.S. railroads get around ¼ of their volume from coal versus less than 10% for the Canadian rails, like CN and CP.) Growth in the transportation of fracking sand and oil has provided some offset for the rails.

A weak global economy and weak commodity prices buttress our case for emphasizing dividend income. It also brings to mind Warren Buffett, who likes to invest in companies that “buy commodities and sell brands”. The most extreme example of brand awareness I can think of is Nike, whose Air Jordan brand is so sought after that its arrival in stores can cause bedlam.

When talking about stocks I must be careful to make clear what time frame I’m referring to: secular, cyclical, or seasonal. Demographic trends, such as an ageing population, are a secular factor favouring the pursuit of dividends. The global economic slowdown is a cyclical factor in favour of dividend investing. The weather is a seasonal influence.

While enjoying some fine spring weather in the country this past weekend (Easter), I attempted another investing lesson on my 6-year old son. (You may recall his first lesson from my New Year’s letter. While he and his Mother were being seasick in January, I tried to tell them that ocean sailing is just like investing, to avoid seasickness you have to stay on deck and focus on the horizon. It seemed appropriate given the very volatile markets at the time, but frankly it didn’t go over very well.) In the country, young Matthew and I noticed the longer days, the budding trees, the chirping birds and the sprouting flowers. It was cheerful. But Matthew, I said, when it comes to investing, ‘sell in May and go away, come back again after Labour Day.’ That is, sell stocks when the days get long, buy when the days get short and we all get gloomy with Seasonal Affective Disorder (SAD). This seasonal pattern in the stock market only works about 3 out of 4 times. Yet seasonality worked spectacularly over the last 6 months: From Oct. 1, 2011 to March 31, 2012, the S&P/TSX is up 8.1% and the S&P 500 is up 19.7% in Canadian dollars (although most of the world’s stock markets are down over the last 12 months). Spring is blooming, stock prices have gone up, two reasons to patiently harvest dividends until the Fall.

Sincerely,



George Stedman, CFA
Portfolio Manager

Please visit us at www.georgestedman.com