



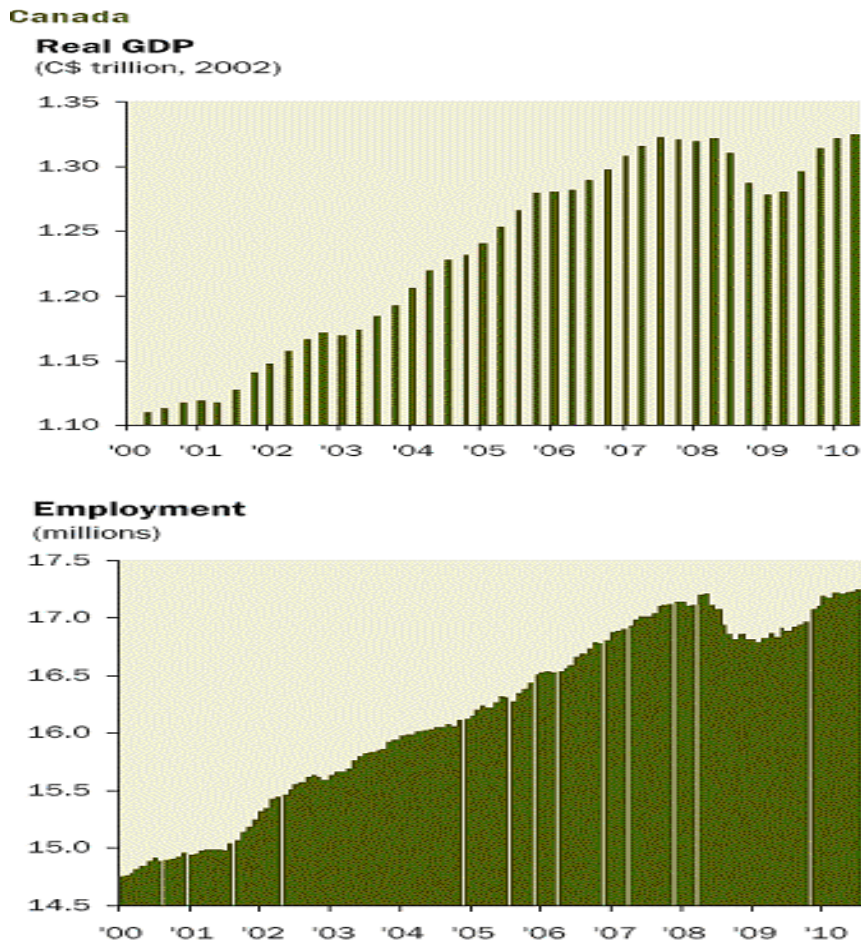
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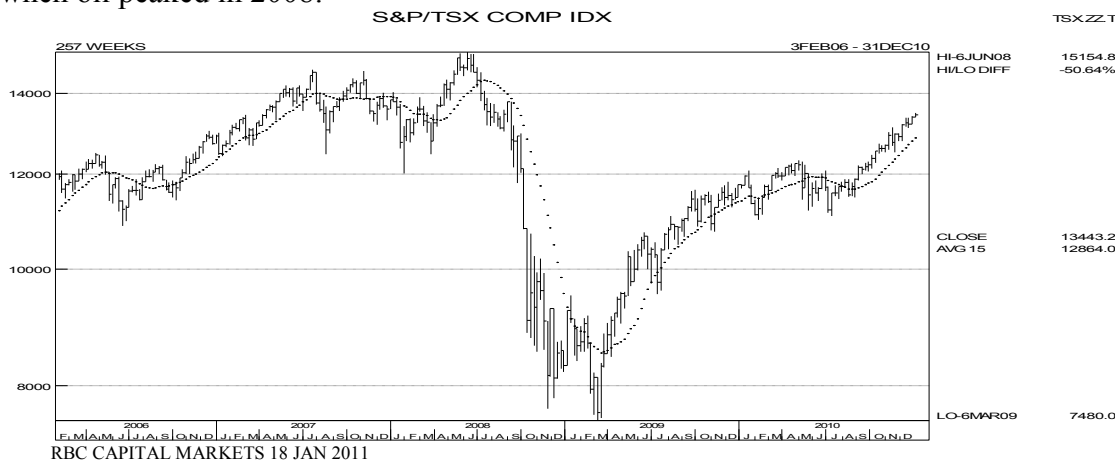
### NEW YEAR 2011

In 2010 stock prices and economies continued their recovery from 2008's trauma. In Canada, one of the most fortuitously positioned countries, real GDP and employment are now back to pre-recession levels:

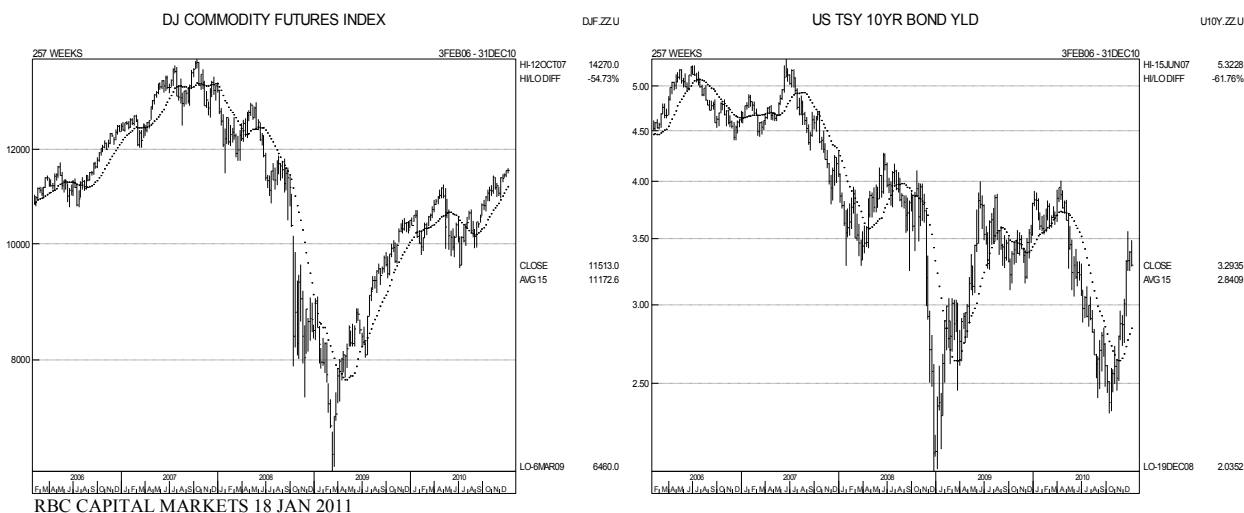


Source: Statistics Canada: Jan. 14, 2011

Canadian stock prices too, buoyed by commodity prices, are nearly back to where they were when oil peaked in 2008:



The S&P 500 (the U.S. index of large companies) went from 1219 in April to 1010 in the summer when all the talk was of a second dip into recession. It ended the year at 1257. What changed was that on August 22 Federal Reserve Chairman Ben Bernanke gave a speech at a conference in Jackson Hole, Wyoming. He implied that the Federal Reserve would again use quantitative easing (I discussed QE2 last quarter) and from that point, stocks took off. Rising government debt has so far been good for stock prices, commodity prices, and the Canadian dollar but bad for bond prices (remember fixed income prices fall when interest rates rise). Ten year U.S. Treasury bond yields moved up from 2.35% last fall to 3.5% at year end:



The Fed is now far and away the biggest buyer and holder of U.S. Treasuries. Otherwise bond yields would be higher still. Eventually the Fed's balance sheet will fill up.

In the stock market two factors appear to have been at work. 1) Investors have had an increased appetite for risk and 2) an increased suspicion of government indebtedness.

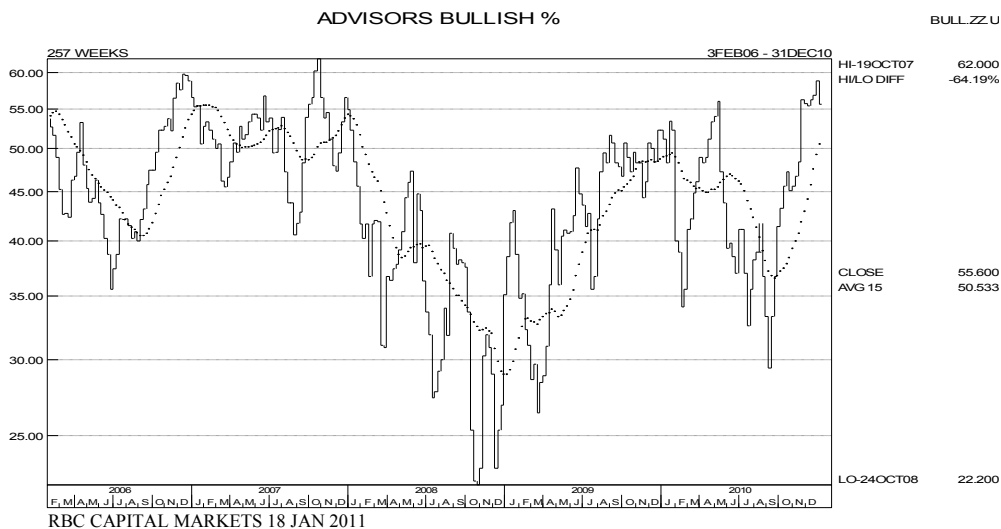
Since the winter of 2008-2009 the 'risk-on' trade has led to sharp gains in stocks, especially in emerging markets, commodities and, commodity related currencies.

Also, some investors seem to have begun to notice not only the Eurozone's debt problems but that U.S. government debt, at 96% of GDP, has reached a level that has caused problems historically and not just for third-world countries. Real assets – bullion, commodities and arguably stocks, offer an alternative to faith in currencies. (You see it is possible to be gloomy but be bullish about stocks). Although there has been much political rhetoric about government borrowing in the U.S., politicians only seem serious about attacking symbols of spending, not the actual entitlement programs (social security, pensions, Medicaid) and military spending that make up the great bulk of U.S. government spending.

The suspicion is growing that the governments of not just the United States, but Europe, Japan and others will be unable to either raise taxes or cut government spending enough to honour their obligations. For Canadians, all this concern about government debts is a case of déjà vu all over again. In 1995 Canada was deeper in debt than Italy and the Loonie was known as the Northern Peso. Canadian government debt reached 110% of GDP. One third of government revenues went to interest costs. By comparison interest expenses consume 10% of U.S. tax revenues today (See *The Canadian Century: Moving Out of America's Shadow*, by Crowley, Clemens and Veldhuis). The threat of intervention by the International Monetary Fund and an expanding global economy proved fortuitous in helping Canada get its public finances in order. The dramatic austerity measures recently announced by the new government of the United Kingdom are said to have been modeled on the success that Canada had cutting government spending in just a couple of years in the mid 1990s under Jean Chrétien and his Minister of Finance, Paul Martin. Alternatively, if governments are unable to pay their debts, rather than default, they can instead print money, and create inflation to reduce their real future obligations.

For the last 30 years ( the length of my career ) interest rates and inflation have more or less steadily gone down and long-term bonds have therefore been extraordinarily good investments. A rebirth of inflationary pressures would be a profound generational shift. As we toy with that possibility, we've introduced, for instance, floating rate preferred shares to taxable accounts and have maintained some short term bonds as some insurance against future inflation.

In 2009, and up until last fall, investors crowded into bonds. More recently they have rediscovered an appetite for stocks. Investor's Intelligence is reporting that the percentage of optimistic advisors is at the highest level since 2007:



In this environment I am happy to own a little cash, or at least short-term bonds. Last quarter I quoted Bruce Berkowitz on how the one thing great investors have in common is that they never run out of cash. Recently, Jeremy Grantham of GMO said investors who disdain the zero returns available now on cash are underestimating the “optionality” of cash, the worth of having money to invest as opportunities present. Stocks have almost doubled since March of 2009, there may well be a ‘correction’ and my prediction for stocks in 2011 is: I expect volatility.

I have often pointed out the usual seasonal pattern in stocks suggests buying in the fall. Last year however the lows came in July. Last January I drew attention to the Presidential cycle, suggesting the start of a new four year cycle in late 2010 and a good 2011 for stock prices. The rationale for a Presidential cycle is that in the third year of a President’s term he is usually focused on getting his party reelected. For example, putting GM into bankruptcy in year one of the Obama presidency and out of bankruptcy late in year two may not be a prescription for sure electoral success but, cutting taxes ought to help. Obama recently agreed to the extension of the so called Bush tax cuts.

British Prime Minister Harold Macmillan, it is said, was asked by a journalist after a long dinner, what is most likely to blow governments off course. His reply – “Events dear boy, events.” And so it is with investing. Forecasting is fun, but events happen and will no doubt in 2011 too.

We wish you a safe and sound new year.

Sincerely,

George Stedman, CFA  
Portfolio Manager

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