

Thursday, July 14, 2011

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Second Quarter 2011

Stock prices were down in the second quarter (the S&P/TSX Composite Total Return Index, -5.1%; the S&P 500 TR, -0.6% in Canadian dollars; and the MSCI World Index, -1%) and were not much changed in the first half of the year. Your rate of return for the last 12 months and for 2011 so far (as well as for various unmanaged indices) are attached.

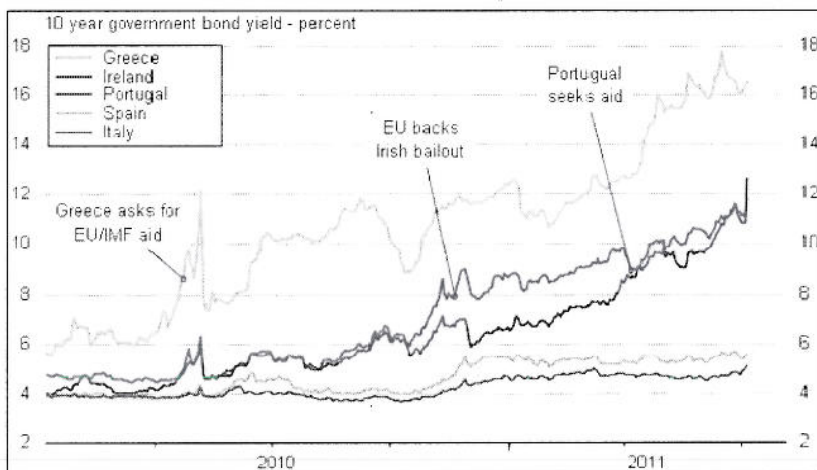
A variety of factors around the world weighed on stock prices, beyond the usual seasonality (“sell in May and go away, come again after Labour Day”).

The government of China has been attempting to slow that country’s rate of economic expansion to dampen inflation. The Chinese have raised interest rates three times this year and have tightened bank reserve requirements several times. They (the Politburo – 5 to 9 men in suits) are attempting to engineer a ‘soft landing’, whereby inflation and speculation are wrung out by tighter monetary conditions but without causing a recession. Low interest rates on bank deposits compared with the rate of inflation have been pushing Chinese investors into the property sector. Concerns that the leadership may not be fully in control of China’s command economy and that the property bubble there may burst are impacting Canadian commodity producers, including energy stocks (which make up a third of the Canadian S&P/TSX).

Standard and Poor’s (S&P) recently lowered Greece’s credit rating to CCC. Now it’s S&P’s lowest rated nation in the world. European authorities have demanded austerity measures from Greece in return for financial aid. Demonstrations and riots in Greece suggest a risk that if the government cuts too deeply the social fabric could become unglued. European authorities would appear to prefer to push Greece’s bankruptcy out long enough to give the bigger PIIGS (Portugal, Ireland, Italy, Spain. Greece only has 11 million people) time to get their government budgets in order and to get all (counter) parties prepared for whatever avalanche Greece’s default loosens. So far, among European corporate borrowers, only financial firms are greatly affected.

From a Canadian perspective, Europe appears badly constituted. It is as if Canada’s wealthy provinces supported our poor ones without controlling an effective national parliament. A situation that does not appear to be sustainable. Today the probability of default within the next 5 years implied by credit markets is 85% for Greece, 23% for Spain. Repeated bailouts appear to have had little impact on Euro-periphery bond yields relative to ‘core’ Europe. The chart below illustrates the rise in yields on 10 year European government bonds:

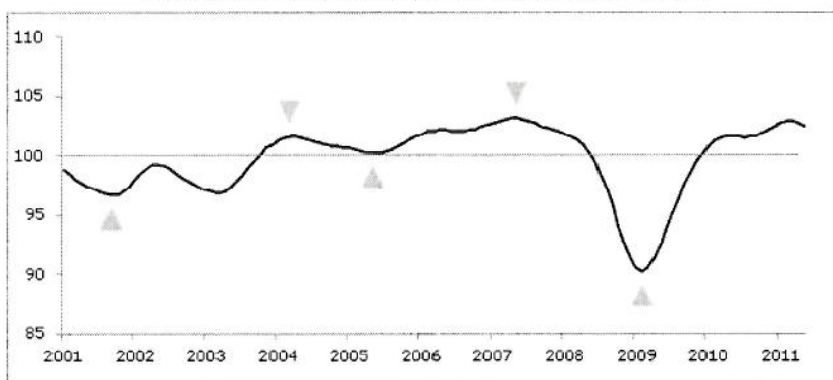
Euro zone bond yields



Source: Thomson Reuters DataStream, July 07, 2011

Also weighing on stock prices were disappointing economic data from the U.S. and globally (especially Japan). The S&P 500 derives roughly 35% of its top line from abroad. The OECD composite leading indicators are designed to anticipate turning points in economic activity. The data for May 2011 released in July point to a slowdown in most major economies.

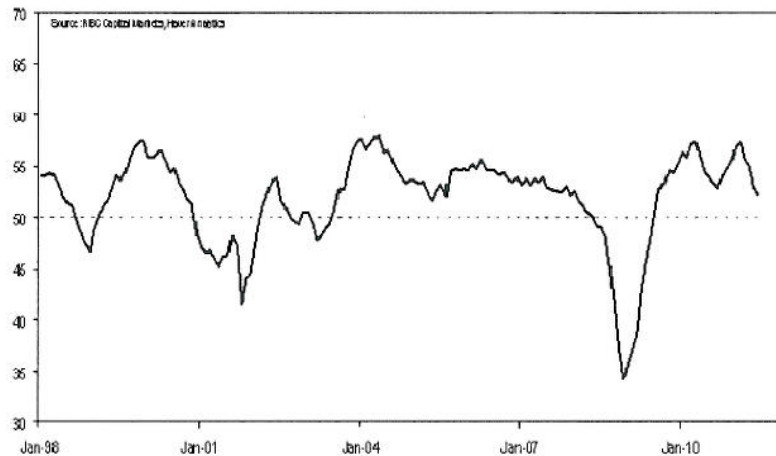
Potential slowdown in the OECD area



Source: The OECD composite leading indicators, July 11, 2011

More than two years have passed since the Great Recession ended but the economic recovery since has been hobbled in the U.S. by the 'new normal' effects of an overhang of unsold homes and the end of governmental stimulation. This spring's economic soft patch in the U.S. (trends in manufacturing, housing, vehicle sales, personal spending, customer confidence, and employment were worse than expected) are part of a pattern of economic fits and starts of the last two years. The Institute of Supply Management's Manufacturing Index slipped in June back down to levels of a year ago, although it still generally indicates an expansion of the overall economy.

Global PMI: Manufacturing



Source: RBC Capital Markets, July 5, 2011

The above noted 3 factors: an attempt to engineer an economic ‘soft landing’ in China; to manage peripheral Europe’s insolvency; and an economic ‘soft patch’ in the U.S. and around the world; have had the consequence of continued low interest rates. Indeed, the Canadian bond market index returned 2.5% in the second quarter. Low bond yields (high bond prices) have reinforced our stock strategy of obsessing about future dividend yields.

Assumptions about interest rates appears to be at the heart of a difference in opinion between Jeremy Grantham, of GMO, and Jeremy Siegel, author of the bestselling *Stocks for the Long Run*, which was described by Brian Milner in the *Globe and Mail* (July 11, 2011). Grantham considers stock generally expensive but big blue chips to be good relative value. For Siegel “stocks have never been so favorably priced in an environment of ultra-low interest rates like we’re experiencing right now” – *Financial Post*, June 29th, 2011.

Barron’s (July 9, 2011) broke down the valuation of stocks; “the S&P 500 multiple on the next 12 months’ forecast earnings is below 13, thus seemingly cheap. Yet the biggest 30 mega-cap stocks are so inexpensive and scorned that the other 470 together trade right at their long term average ...” It is no wonder that in our continuing pursuit of dividend yields we have been frequently drawn recently to the cheap and orphaned mega-cap equities.

Sincerely,

George Stedman, CFA
Portfolio Manager

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