

Monday, January 16, 2012

Year End 2011

In 2011 Canadian stocks, (-8.7% as measured by the S&P/TSX Composite Total Return Index) lagged U.S. stocks for the first time since 2003 (the S&P 500 Total Return in Canadian dollars was 4.4%) and by the most since 1998, when oil was \$11 per barrel. The MSCI World Index split the difference and returned -3.3%. The European debt crisis weighed down financial stocks and slowing growth in China sank commodity stocks. Mining and energy stocks make up almost half of the Canadian stock market index and financials account for nearly another 30%.

In 2011 the reemergence of dividend investing favored utilities, foods, healthcare and consumer staples stocks, groups which are more prevalent in the U.S. stock market. The S&P 500 was the only benchmark index of 24 developed markets that advanced last year. So called defensive industries take up three times as much of the stock market value in the U.S. as they do in Canada. The chart below, from RBC's Bob Dickey, compares the S&P 500 Utilities sector to the S&P 500 Financial sector:

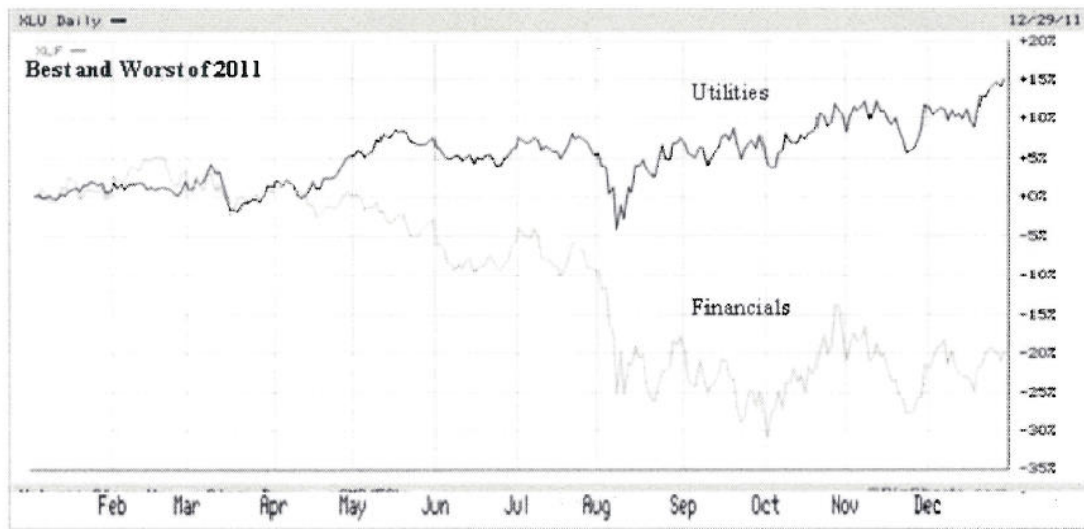
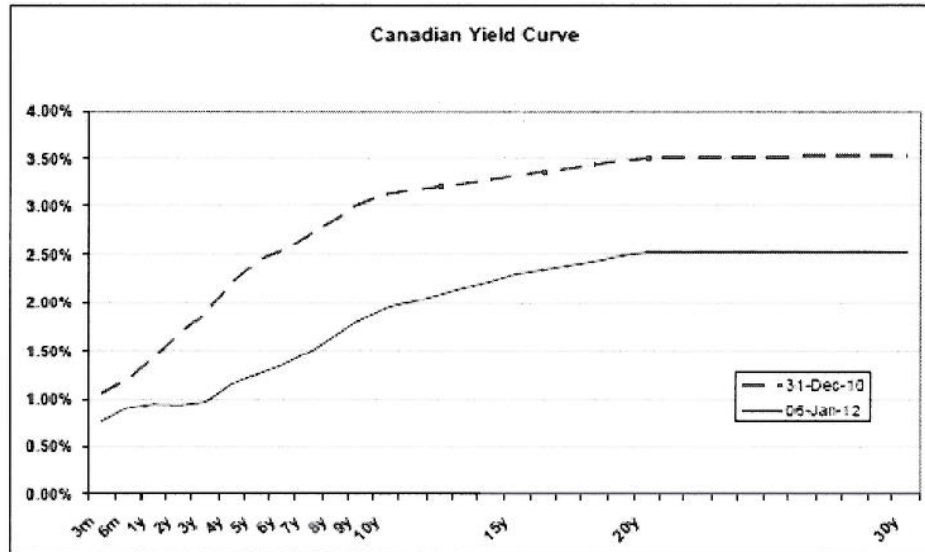


Chart courtesy Bigcharts.com and RBC Wealth Management
Dec 29, 2011

I have been fretting about the risk of an increase in interest rates for a couple of years already. 2011 showed once again that the only reason for me to predict interest rates is to be wrong. Interest rates moved steadily lower in 2011 and bonds did very well. The yield curve is comprised of the yields of various Government of Canada bonds that trade in the secondary market. The chart below displays the Canadian yield curve at the beginning and end of 2011. The dotted line is the yield curve at the start of the year, the solid line at the end of the year. The chart shows that there was a substantial shift downward across all maturities in 2011.



Source: Bloomberg, RBC DS
Jan 6, 2012

North America central banks' near zero interest rate policy continues. The negative real return from cash certainly creates pressures which to some extent need to be resisted.

According to Bloomberg (Dec 15, 2011) the stock market has had record volatility since August and hedge funds are on track to post their second worst year on record. Never has there been so much volatility over so long a period. Bloomberg reported that Dow Jones industrial Average swings since Aug. 1 averaged 261 points (Dec 15, 2011) between intraday highs and lows. The massive volatility in the last 4 months of 2011 came largely from the swell of rumors and headlines from Europe. Investors could have been swamped by feelings of seasickness for which, as I recently told my 5 year old, the only antidote is to stay on deck and to focus on the horizon. A long time horizon can seem to dampen volatility.

What is on the investment horizon is foggy. The high risk of a financial chain reaction propagating from Europe is clear. What is unclear to me is the nature of the risks. Hyperinflation? Deflation? For example, Bill Gross says (Towards the Paranormal, January 4, 2012) "The dollar is king with a left-tailed [unforeseen] delevering scenario – pauper in a right-tailed global reflationary expansion". The old saying goes, "you can't have good news and cheap stocks at the same time" (Joe Rosenberg in Barron's, December 24, 2011). There sure seems to be plenty to worry about today, but in the 30 years that I've been doing this I've often felt a little queazy.

Happy New Year.

Sincerely,

George Stedman, CFA
Portfolio Manager

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