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Summer 2011 Economic Commentary

By Kurt Rosentreter

It is time for our once a year economic commentary, a forward-looking crystal ball prediction of financial markets based on current news and economic conditions from around the world.

We limit our public commentary on the markets to once a year, and even debate providing it at all, for several reasons: i) market forecasts are best guesses, nothing more, and the list of failed projections month after month from much lauded market gurus far exceeds the list of correct projections. Investing based on these forecasts may feel good, but there is lots of research showing they do little to improve your likelihood of investing success long-term; ii) every investor is at a different stage of life with different financial circumstances warranting a unique investment approach suitable to that person; iii) in our practice we invest fundamentally, selecting securities that give sound business reasons to invest in – similar to the style of Warren Buffett, the world's most successful private investor.

From a tactical perspective, we do track the movement of every major market in the world everyday – and our team meets and debates weekly how to position investment portfolios giving consideration to major macro trends evolving over years. Here are our thoughts on the rest of 2011:

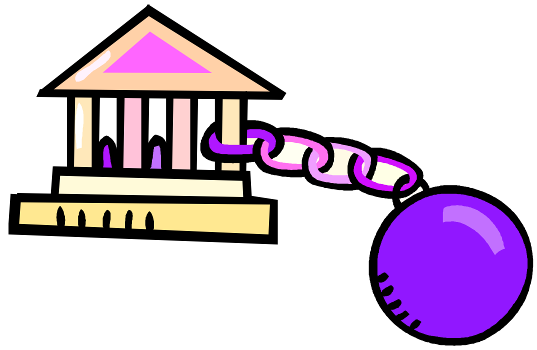
2011 – A Year to Fall Back?

In a typical ten year investing period in the past, one has been able to expect four years of negative returns and six years of positive returns in random order. Across these ten years however, the ups have exceeded the downs and resulted in an average annual rate of return per year of approximately 10% (source: Bloomberg—S&P500 US Index from 1936 to 2010 is 9.99% per year). After two good years, we feel there are many reasons to expect 2011 to be one of those negative stock market years.

The Importance of Corporate Earnings

After two powerful rebound years in 2009 and 2010 that saw the stock market bounce off one of the deepest stock market corrections in history, we feel that 2011 is poised to be a "down" year. It seems the global markets are simply running out of steam – strong corporate earnings that had fueled high markets quarter after quarter since 2009 are poised to fall based on higher commodity prices (e.g. oil, minerals), eroding profits and lackluster demand from consumers failing to drive sales. If corporate earnings reports don't continue to show rising earnings (ideally, beating market expectations), count on the stock market to fall back in the short term. More than anything else, short term stock market gains are driven by rising corporate earnings expectations. The good news is that this softness should not be a long lasting effect in our opinion – eventually the world will kick into gear and earnings will start to grow again. We do not foresee a return to recession although there are major events on the horizon that could stall the ongoing recovery.

Debt and More Debt

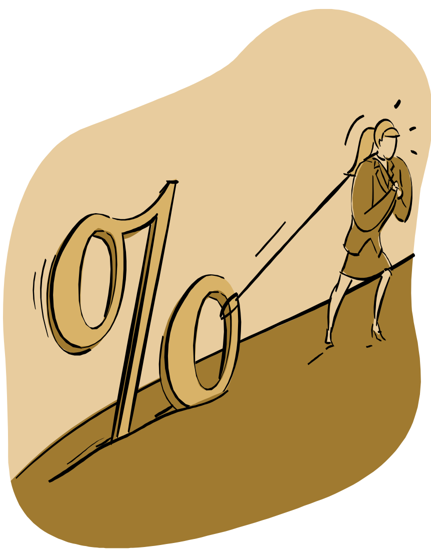


Countries like Greece continue to be in the news as the world wonders if they can manage their sky-high debt level as a country. With much of their debt held by German and British banks, the entire European community has much at stake if Greece goes down. That would surely affect us in Canada as well.

And then there is the U.S. A few weeks ago, they reached their legal debt limit as a country and are now faced with approving legislation to raise this limit or cut spending. This is poised to play out in the summer of 2011 with the Republicans and Democrats playing a dangerous game of chicken that holds the entire world in balance. If the U.S. doesn't get their debt under control in the next few years, the world's largest economy could face economic setbacks that pull the entire world into a nasty second recession in our opinion. The world needs to see that the U.S. has their debt under control – currently there is no indication of this and the stock market is worried about the implications.

Is the Canadian Stock Market Safer?

There has been much made about how well Canada's economy performed (survived) compared to the rest of the world during the worst of the 2008 / 2009 recession. And we are all thankful for that. But when you look at the Canadian economy, is it really as safe as it appears? With so many Canadian's RRSPs over weighted in Canadian blue chip stocks, have we over concentrated our savings and bet the farm on a single, small country? Here are a few things to consider: i) Canadian banks – they are not the largest banks in the world and they are closely tied to each other and the housing market in Canada – a major real estate correction in Canada (and we are overdue!) could wreak havoc on the profitability of our banks, and the failure of one could affect the others; ii) the TSX stock market – our stock market is one of the most poorly diversified in the world, with 40% of the market consisting of financials and 40% consisting of resources. Two industries dominate our country's economy and we have little to fall back on should these industries take major economic hits in the years to come; iii) recent new stories in Canada have highlighted the fact that the average Canadian now has more debt than the average American; iv) should our country get into serious economic difficulty, our dollar could drop like a rock reflecting the fact that we are only 2% of the global economy.



Overall, with your career or pensions in Canadian dollars, your Canadian dollar home and your Canadian cost of living, taking a Canada-only investing approach with your RRSP and broader investments leaves you with too little global diversification in our opinion – we believe that Canadians should take advantage of our strong dollar currently (more than par with the US dollar) and diversify, diversify, diversify globally like never before – the best "deals" today appear to be in US real estate and blue chip securities, Europe and emerging markets.

Interest Rates

The Bank of Canada has not raised interest rates lately and it doesn't look like they will in the first half of 2011 either. You can blame a shaky stock market in Canada and the US, along with continued high unemployment and an already high Canadian dollar. As long as inflation stays in check, we are of the opinion that the Bank of Canada will keep interest rates at this level until 2012. While this is good for younger Canadians with mortgages, this is bad for older Canadians seeking to own low risk investments like GICs. Currently bond yields and GIC rates continue to be among the lowest rates in the last half century – making it hard for a retiree to invest conservatively and generate adequate retirement income.

Beyond 2012 however, if the economy and employment conditions continue to improve, this could put upward pressure on interest rates. Mortgage holders should plan to lock in before then and bond investors should stay short term with new maturities (under 4 years) and patiently await better returns.

Canadian Dollar

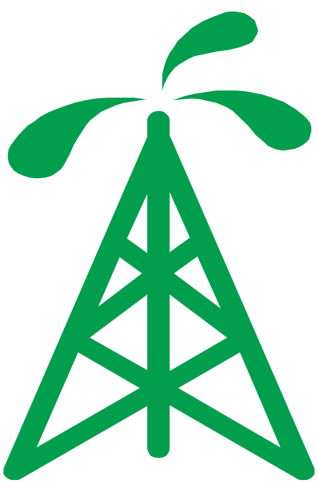
At the time of writing this newsletter, the Canadian dollar was at 1.01 to the US dollar. Above parity, and likely to stay around parity for at least another year, in our opinion. What could drive the Canadian dollar below 90 cents faster? Two situations: first would be a catastrophic economic collapse in Canada, perhaps triggered by a significant real estate correction that would see young couples bankrupt under the weight of their mega-mortgages; second, and a happier scenario from a global perspective, is the US government adopting strong medicine to clean up their debt ridden economy, perhaps through a combination of cost cutting and tax hikes. The problem is that there is no appetite for this, particularly ahead of a 2012 presidential election. Neither major U.S. political party will rock the boat ahead of the election, fearing lost votes if they take the steps that the rest of the world feels they need to take.

Canadian Real Estate

With Canadian personal real estate at record high levels in history, we are extremely worried that the market has reached bubble proportions, fueled by low interest rates that have been maintained too long.   Most exposed are young families who have sacrificed everything to buy big, and now carry record large debt floating at artificially low interest rates. Sound like the US three years ago? Let's hope not. The test will come when the Bank of Canada starts to raise market interest rates and mortgage rates rise correspondingly. Investors may want to hang tough with their current homes for now. Retirees contemplating downsizing may want to sell their current home now.   We would like to see Canadian real estate prices rise forever, but practically as planners we need to look at your finances defensively first, and the worst case scenario could be devastating.

Emerging Nations

The top performing stock markets in the last five years ending June 2011 have been stock markets from countries like India, China, Mexico, Brazil and other up and coming economies. Many news stories talk of China's 10% economic growth per year, Brazil's resource wealth, India's hundreds of millions of educated workers and their needs for the world's help to industrialize these nations. With western nations viewed as mature economies and with aging populations in decline, these emerging economic tigers could prove to be the growth stories of the rest of our lifetimes. While these stock markets will prove to be tremendously volatile because of their instability, simply put: you have to be there as an investor. We are confident that investing small amounts on a regular basis into these nations will provide above average returns for decades to come.



Commodities

We continue to be bullish on core commodities securities in the oil, mining and agriculture industries. With a billion people (20% of the world's population) prepared to move into middle class status in the next few years (think China and India), they will all need gas for their first cars, copper piping for their new homes and food for their growing families. In the next 25 years, we feel strongly that owning these three commodity sectors (stocks, funds or indexes) should reap profits for the portfolio.

Aside, note that Canada as a country is dominantly positioned in these three commodities.

Investment Strategy

With all this coming at you, our team of six strategizes weekly to contemplate revisions to the existing investment plan that we have created together with you.

Recognizing that every investor is different and specific recommendations are impossible to give in a newsletter designed for general advice, here are key considerations from our team:

- We have a plan – stick to the plan. Set a strategic asset allocation. Follow structured rebalancing, profit taking and new investing benchmarks. Put short term news in perspective.
- Don't get greedy – take profits on successful investments on a routine basis;

- Don't get greedy #2 – don't blow up our existing investment plan or asset allocation by selling bonds to chase the stock market's bigger returns. Bonds are never purchased for returns – they are purchased for cash flow, liquidity and stability. Owning boring bonds or GICs act as a portfolio stabilizer and can lead to better average returns over time.
- Rethink owning stocks – with the recent emergence of ETFS (indexes), ETFs (and funds) offer the transparency and low cost of owning stocks, but they diversify away the business risk of holding a stock by owning a bundle of them. Had you owned an index of stocks, you would not have been whacked as bad when bad news hit businesses like CIBC, Teck Cominco, Citigroup, Enron, Hewlett Packard and the latest disaster: Sino Forest.
- Stay with short term GICs for now – everyday we check the bond markets to see if bonds of various types offer beater returns than GICs. The answer is no, not yet, and it has been this way for a few years now. Only junk bonds, lower quality bonds, offer better returns – but with a lot more risk in some cases. Stick with the GICs, stay short term (under 4 years maturity) and wait for better yields in the future. We promise to buy you a 30 year bond when we can once again get 8% for a bond or GIC.
- We expect stock markets to continue to drop this summer of 2011 – for younger investors saving for the future, you should hope they fall a lot – and then use this opportunity to buy into the stock market at low prices. After all, isn't that the goal – buy low, sell high? If it keeps falling, keep buying, perhaps even borrowing money to do so in the right circumstances. For older investors, hold firm – take comfort that your securities are top quality, many of which will continue to pay dividend cash flow even while the markets fall. If you find the market correction unnerving, it probably means you have too much in the stock market and we should revisit your "true" risk tolerance. When market conditions recover (or sooner if necessary), we can rebalance you to a more conservative profile. Similarly, if you are retired and spending more than the portfolio earns in a year, a negative stock market year means you should try to spend less this year. Your portfolio will go further if you can limit your discretionary spending to occur in positive stock market years. In other words, minimize spending capital base and try to live off income and gains alone.

Our Next Meeting

It is important that we communicate regularly about your financial plan, changing goals and priorities and of course, your investments which serve to feed your goals. We will routinely schedule appointments with you – if it is not enough (or too much!) please let us know and we will adjust our communication planning. We are here for you and will meet as often as you want.

Contact Laura on our team now at 416.628.5761 or 1.866.275.5878 Ext 239 to schedule your next review meeting or call.

Other News…

We're Moving!

After an 18 month search, and as the end of our lease nears, we have decided to move to downtown Toronto at the end of August 2011.
Our new address is Suite 302, 3 Church Street in the financial core. Our phone number will not change. Stay tuned for formal address changes in the mail and directions to the new office.

Our Team Has Reached Ten!

We are pleased to announce that our advisory team has reached six direct professionals and four secondary professionals for a total team of ten financial advisors and support staff to assist you from our office. Our team has well over 100 years of experience assisting clients and we are qualified as experts in financial planning, investing, insurance, debt, taxes, estate, children's savings and cash flow management. Visit www.kurtismycfo.com to read the biographies of each team member – they all know who you are already!

Tax Time Follow up

By now you should have your income tax notice of assessment that was sent out by CRA after you filed your personal tax return. Send us a copy of this important form so we can track your RRSP contribution room, tax bracket, Tax Free account contribution room and other important tax tidbits.

Prescribed Rate Loans – The Tax Opportunity of a Lifetime

Two spouses can split income between each other and pay less income tax as a family using the prescribed rate strategy. This works for couples where one spouse is in a high tax bracket and has significant taxable investment assets. Contact us soon to learn more about how to reorganize your finances to take advantage of this technique.

Do You Have A Corporation?

Whether you are a business owner or an investor, if you have a corporation (or several), you require special planning that can evolve over the years. Tax planning, estate planning, investment planning and insurance planning are four key areas that can affect how you manage your corporate interests. An accountant may only scratch the surface in these planning needs.
Contact us for a specialized planning session to review your corporate structures.

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