

## Investment Outlook

July 2010

### It Was a Good Time, but Not a Long Time

Three months ago investors were heartened by the undeniable signs of an economic recovery. GDP growth rates in Canada and the U.S. had rebounded sharply, labour markets had shown meaningful improvement, and measures of consumer and business confidence increased impressively. Reflecting these improved economic conditions, the stock market recovery, begun in 2009, continued.

Over the course of the three months just ended, however, stock markets in Canada and the U.S. both retreated. In fixed income markets, prices rose and interest rates fell. In fact, yields on U.S. Treasuries fell back to levels last seen in the depths of the credit crisis. The stock and bond markets are discounting mechanisms; prices in both markets try to anticipate economic conditions and corporate profitability in the future. At present, it seems both markets are forecasting renewed challenges. They point to economic weakness, profit disappointment, and even the risk of deflation. In its most recently released minutes, the U.S. Federal Reserve acknowledged that “underlying inflation has trended lower.” While these do not seem like dramatic words to most of us, they are significant in the eyes of those who analyze the Fed’s pronouncements closely. Some investors fear a dreadful period of declining prices and stagnant economic activity such as gripped the U.S. in the Great Depression, and Japan in the ‘lost decade’ of the 1990s.

In contrast, the price of gold reflects a potentially different set of economic conditions. At current prices over US\$1,200/oz. gold seems to reflect a fear of inflation rather than deflation. As governments around the world scrambled to stabilize their economies, some of their actions amounted to little more than the printing of money. The worry is that this excess liquidity will inevitably lead to inflation and the potential for monetary debasement – a situation where paper money just isn’t worth what it used to be. These conflicting market signals make it a confusing time for investors.

Over the last several weeks, the regular flow of economic data has turned decidedly more worrisome, especially in the U.S. Many measures of housing market activity suggest that the fallout from the U.S. house price collapse is incomplete. Eight million mortgage loans remain in some state of delinquency, default or foreclosure, and 100,000 new notices of default are sent out each week. Buoyed by significant tax incentives (part of the massive government stimulus programs), the U.S. housing market seemed to stabilize in 2009. As these tax incentives expired, so too did the stabilization. In June, the National Association of Realtors index of pending home re-sales plunged 30%. As we feared, it seems that the tax incentives may have done little but bring forward future demand, rather than fixing the underlying issues.

The U.S. labour market, which likewise had buoyed hopes of recovery, has stumbled once again. Following a recent trend of rising unemployment insurance claims, the employment report for June squashed hopes for a quick return to healthy labour market conditions. U.S. payrolls declined by 125,000 in June as many of the temporary staff needed for the U.S. Census were released. While the ‘official’ unemployment rate fell to 9.5% from 9.7%, this was entirely the result of 652,000 individuals leaving the workforce. Had the workforce stayed constant, the unemployment rate would have jumped to 10%. Our preferred measure of unemployment, the U-6<sup>1</sup>, remains elevated at 16.5%. Perhaps most shocking of all, however, is the fact that the average duration of joblessness rose to 35.2 weeks, an all-time peak and a full 14 weeks above the high of any cycle before this one.<sup>2</sup>

The Canadian economy has remained the envy of its G8 partners for some time, and its relative strength continued over the last quarter. Just as this note went to print, the release of a strong employment

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<sup>1</sup> The U-6 is a Bureau of Labor Statistics series that adds to the ‘official’ unemployment rate those who have stopped looking for a job because they can’t find one and those who have taken a part-time job because they can’t find a full-time one.

<sup>2</sup> From *Barron’s*, July 3, 2010.

report for June re-confirms that economic conditions in Canada remain more robust than those south of the border. Reflecting this stability, the Bank of Canada took the first small step towards normalizing monetary conditions by raising its overnight rate from 0.25% to 0.50% on June 1. At the time, this was seen as the first of a series of increases over the balance of the year. However, the softening of economic trends in the U.S. and abroad during June suggests that further rate hikes may not be so imminent. Even rapidly growing economies like China are showing signs that growth may be slowing. With our export-oriented economy, softness abroad will definitely affect us at home.

Much of what has unfolded over the last three months was anticipated in the last several *Outlook* commentaries. While there were clear signs of economic recovery in 2009 and early 2010, we worried about its sustainability. After a period of dramatic economic contraction such as was experienced in 2008, it is normal that there would be a period of cyclical rebound. Eventually, shelves become empty and inventory has to be replenished, even in the most difficult times. Moreover, governments and central banks around the world implemented unprecedented levels of stimulus to help stabilize their economies. This proved effective at stopping the bleeding, but did little to fix the underlying problems. We are now in a phase where these stimulus programs will subside and the recovery will have to be led by the private sector. This transition will be measured in years, not months. As Alan Abelson recently wrote in *Barron's*, "The inevitable sobering up in the aftermath of a quarter-century of credit binge continues to take its grim and global toll."<sup>3</sup>

### **Between a Stock and a Hard Place**

As an investor, what is one to do in the face of these challenges? As always, the answer to this depends on your time horizon. In the short term, there are many uncertainties and risks. The economic environment we have described virtually ensures there will be a bumpy ride in the stock market for the next little while. If you are a short-term investor, it is hard for us to recommend anything but caution.

Fortunately, most Nexus clients have the luxury of being long-term investors. For a long-term investor, the current environment is not nearly so worrisome. Uncertain times often provide great opportunity if one has the foresight to make sensible investments and the patience to let them to play out. A consequence of the renewed worries in investors' minds has been that much in the stock market has become cheap once again. Another consequence, resulting from the flight to the safety of the bond market, is that bonds have become expensive.

This does not mean that bonds are to be avoided. They still provide the characteristics of capital preservation and income generation. For some investors, these attributes are critical. Those with short time horizons or lower risk tolerance often can't afford to accept the volatility that comes along with the ownership of stocks. In fact, most investors require some component of bonds, even at current low interest rates.

Stocks, however, despite the near-term risks and uncertainties, offer the potential for quite satisfactory rewards from current levels. The forward price/earnings multiple on the S&P 500 is below 12, an attractive level by any recent standard, and a substantial discount to the long-term median of 14.9. Thirteen of the 25 largest companies in the S&P 500 trade for 10x earnings, or less. Looked at another way, the S&P 500 earnings yield of over 8%<sup>4</sup> is more than five percentage points higher than the 3% yield on 10-year Treasuries. The last time the gap was this wide was in the late 1970s. The TSX, while not quite so extreme by these measures, also offers compelling investment opportunities.

Stock selection is never more important than in a difficult economic environment. Some companies that have excessive debt levels, or which are not cost competitive, may still be casualties in the volatile environment we are likely to endure. Our approach has always been to invest in companies we believe to be superior to their peers, both in balance sheet strength and in profitability, and to invest in these companies at prices below our assessment of their intrinsic value. At the height of bull markets there are very few such opportunities available. In times like the present, when the future course of events remains uncertain, opportunities abound. We will do our best to take advantage of them.

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<sup>3</sup> *Barron's*, July 3, 2010.

<sup>4</sup> The earnings yield is E/P, the inverse of the P/E ratio.

## FINANCIAL MARKET SUMMARY

### Market Levels

<u>Canada</u>	<u>June 30, 2010</u>	<u>December 31, 2009</u>
TSX Composite Index	11,294	11,746
91-Day T-Bill Yield	0.50%	0.34%
30-Year Gov't of Canada Bond Yield	3.65%	4.08%
Prime Rate	2.50%	2.25%
Exchange Rate (1\$ Cdn. = US\$)	\$0.9429	\$0.9555

### United States

Dow Jones Industrial Average	9,774	10,428
Standard & Poor's 500 Index	1,031	1,115
30-Year U.S. Treasury Yield	3.92%	4.64%

### Market Returns For Periods Ended June 30, 2010 <sup>(1)</sup>

	<u>Last Quarter</u>	<u>Last 12 Months</u>	<u>Last 5 Years <sup>(2)</sup></u>	<u>Last 10 Years <sup>(2)</sup></u>
DEX 91-Day T-Bill Index	0.1%	0.3%	2.8%	3.0%
DEX Universe Bond Index	2.9%	6.9%	4.9%	6.6%
TSX Composite Index	-5.5%	12.0%	5.5%	3.3%
S&P 500 Index (C\$)	-7.5%	4.4%	-3.6%	-4.8%
MSCI EAFE (C\$)	-10.2%	-3.4%	-2.0%	-3.1%

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#### Footnotes:

(1) Represent total returns, including income and capital appreciation (or depreciation).

(2) Compound average annual return.

