BMO NESBITT BURNS

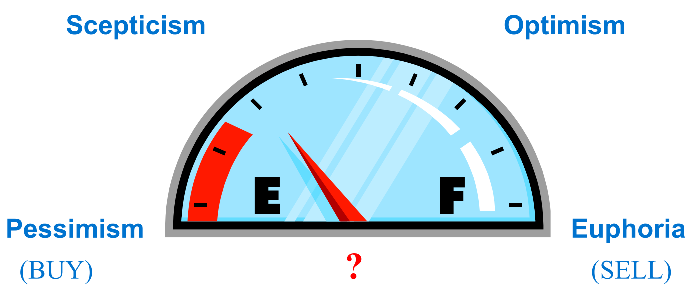
# Morin Dupont Group

*April 2011*

## *Newsletter #45*
**(Excerpt)**

# *The Fed is filling up*

**Confidence Gauge**

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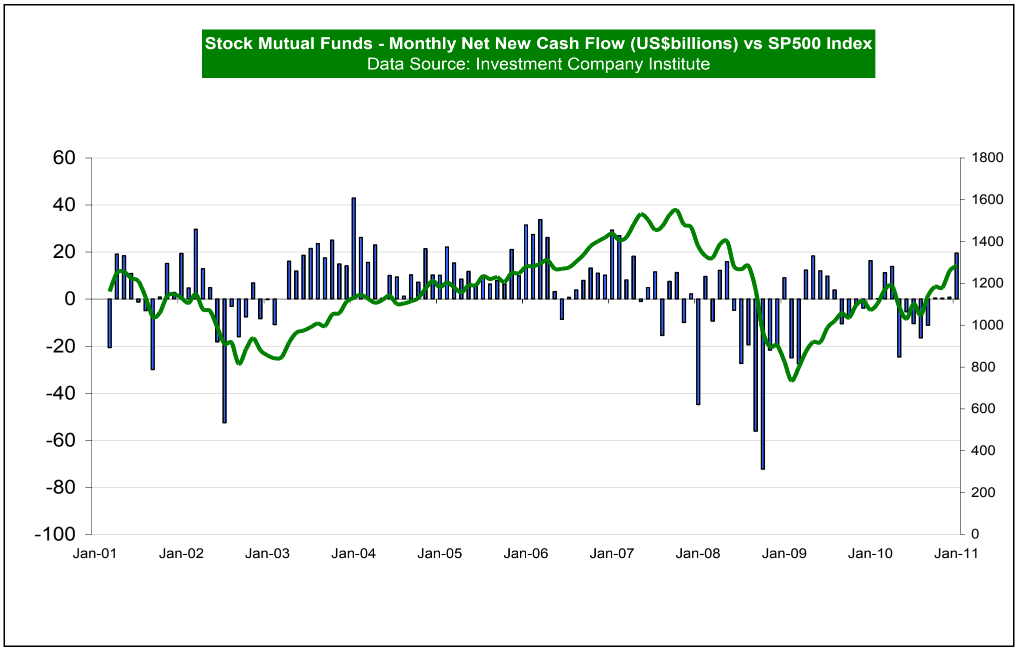
Since the beginning of the year, North American stock markets have shown enormous resilience to all the bad news to which we have been exposed. The European debt crisis continues to make headlines, and now we can add the social unrest that has spread throughout Northern Africa and the Middle East. And as if that weren't enough, the world's third largest economy – Japan – has recently suffered one of the worse natural disasters in its history, triggered by a huge earthquake followed by a devastating tsunami that destroyed a major nuclear power plant and crippled the country's energy supply chain. The related economic impact is being felt all over the world, given that Japan, one of the G7 countries, is a major supplier of goods worldwide. The productivity of many European and American companies, who rely on automotive or electronic parts, may be negatively impacted as their inventories dry up. The question is how much of a slowdown will this unfortunate event cause in an already fragile economy? Could it trigger a deflationary spiral, resulting from an increased number of layoffs and jobs losses?

Although these issues have generated enormous volatility in the markets, past experience shows that such negative impacts usually turn out to be only a short-term setback, since such situations can also create opportunities that others are eager to seize. The recent market turbulence also perhaps turned out to be a good excuse for investors to take some profits as the markets have been on a tear since August of 2010. Yet here again, North American markets have shown great resilience as these events triggered a correction of not more than 5% in Toronto and 7% on the Dow Jones Industrial Average. But where does that resilience come from?

Perhaps the answer lies within money flows and investor confidence. It is a fact that when the market does well, investors become more comfortable and eager to participate. As its popularity grows, however, so do stock prices. Buying stocks when it has become a popular thing to do is generally associated with market highs. A feeling of comfort makes you buy securities at a premium. On the flip side, when the market drops and panic sets in, everyone starts bailing out, and stock prices are usually at a discount. In other words, the global stock market is the only place where buyers chase premium prices and avoid discounts. One measure of this phenomenon is mutual funds flows from bond and money market funds to equity funds and vice versa.

Chart 1 shows significant equity outflows in the summer 2010, when anxiety started brewing about the possibility of a double dip recession and the risk of another September/October nightmare, only to roar back into equities in January 2011, after the S&P had rallied nearly 20%. This recent equity buying spree may be telling us that the market is becoming expensive short-term, and that a correction might be on its way.

**Chart 1**




Source: BMO Capital Markets, Thomson Reuters

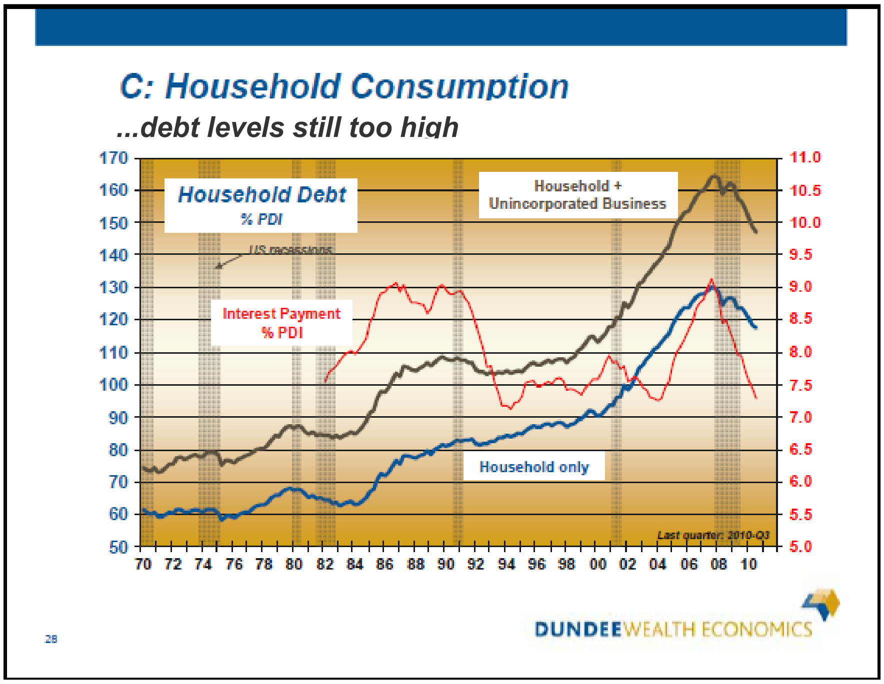
Currently, however, there is a very significant amount of capital in cash and in the fixed income asset class, and these funds will eventually make their way back into the market.

Current monetary policies are also favourable to equities in many ways. First, funds are cheaply available given the low interest rates. Individuals and corporations can readily borrow to fund expansion and consumption. Investing in bonds and the money market, however, isn't so attractive, as the yields are so low. Furthermore, soft monetary policies combined with quantitative easing (printing money) are a lethal combination when you want to stimulate the economy and inflation, which can be best offset by equities. Investors with a long-term view should therefore not worry about any short-term correction given all the stimulus out there and price/earnings multiples well below the last 20 years average (see Newsletter #44, October 2010).

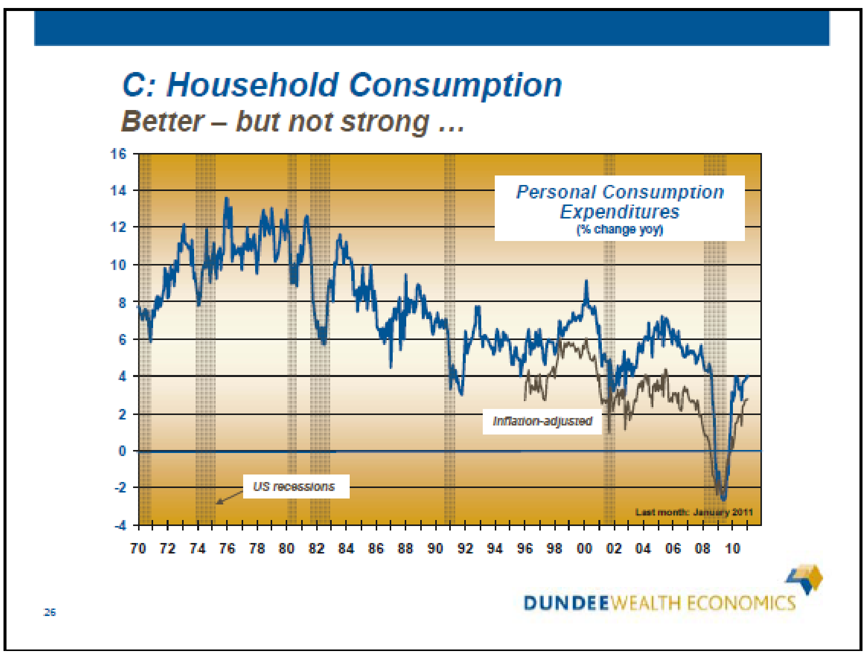
As mentioned in our last newsletter, corporate America is financially doing very well on the back of the Central Bank's generosity and the government's stimulus programs. We have witnessed a stubborn improvement in unemployment numbers although they are now heading in the right direction. We have to admit however, that we avoided a double dip recession thanks to the Federal Reserve's intervention in purchasing up to $600 billion in US Treasuries with freshly printed money (QE2). That new capital is set to run out in June 2011. Can the economy fly on its own when the Fed's support runs out? Will we need another round of quantitative easing? As these questions arise and are debated, it will raise uncertainty, which increases the risk of a correction.

Another issue is the fact that American consumers are running on a stockpile of debt, which limits their ability to spend (chart 2).

**Chart 2**




Source: Dundee Wealth Economics




Source: Dundee Wealth Economics

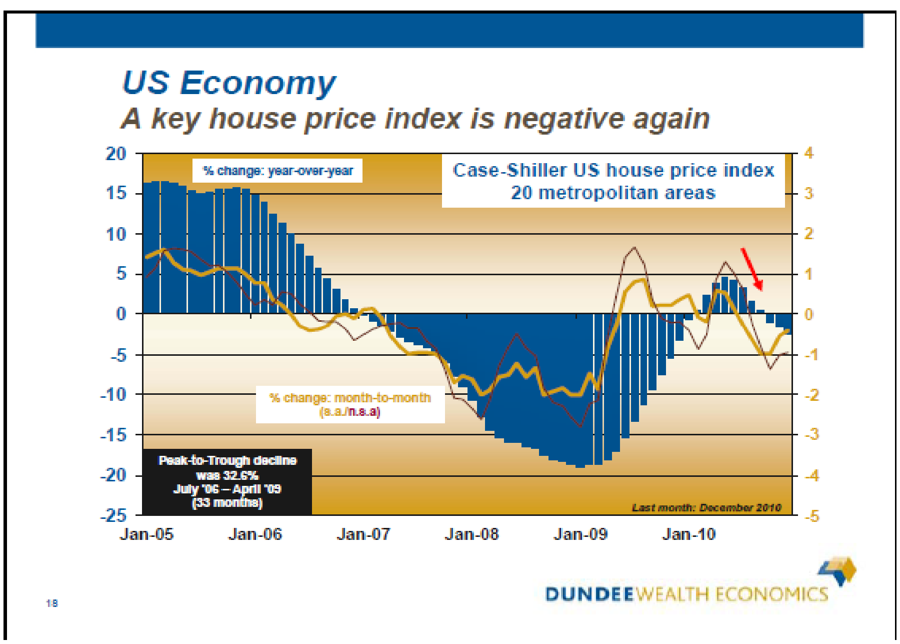
Corporate revenue growth is hard to come by. Profit margins, however, are expanding as companies have been successful in cutting costs and re-financing debt at lower rates. Energy costs, which had come down dramatically, have been increasing again recently, given the political instability in North Africa. Oil costs act like a tax on corporate profits and this may slow earnings growth forecasts. If profit margins are temporarily squeezed, can revenue growth offset them? Given that consumption growth in North America is somewhat subdued, corporations may have to rely on exports. And a weaker US dollar does help in that front.

But strong foreign economies such as India, China and other emerging markets, have been overheating and local governments are determined to slow things down. They are raising interest rates (7 times in both countries), increasing reserves and becoming more stringent on their loan policies as they want to avoid inflationary bubbles. Food inflation, which is the source of the North African political unrest, has reached 15.4% in India this past January. The impact of high food inflation usually leads to the disappearance of the middle class, and this causes social unrest. For this to happen in Asia, with a population reaching 2.5 billion people, would undeniably be much worse than in North Africa.

The paradox is that America depends on the economic growth of countries that are desperately trying to slow down! How long can this last? Great were the days when we were dependant on no one but ourselves! To recapture this independence, we need to revive consumer confidence, but debt levels have compressed our ability to consume at a time when interest rates are at the lowest level seen in 70 years! What will happen when interest rates start to increase?

Perhaps real estate values are another element that comes in play as they represent a significant part of consumer wealth and, consequently, their overall confidence level. Starting this April, there will be another wave of Adjustable Rate Mortgages (AMR) resets in the US. While recently home prices have re-accelerated to the downside, mortgage rates have notched up (chart 3).

**Chart 3**

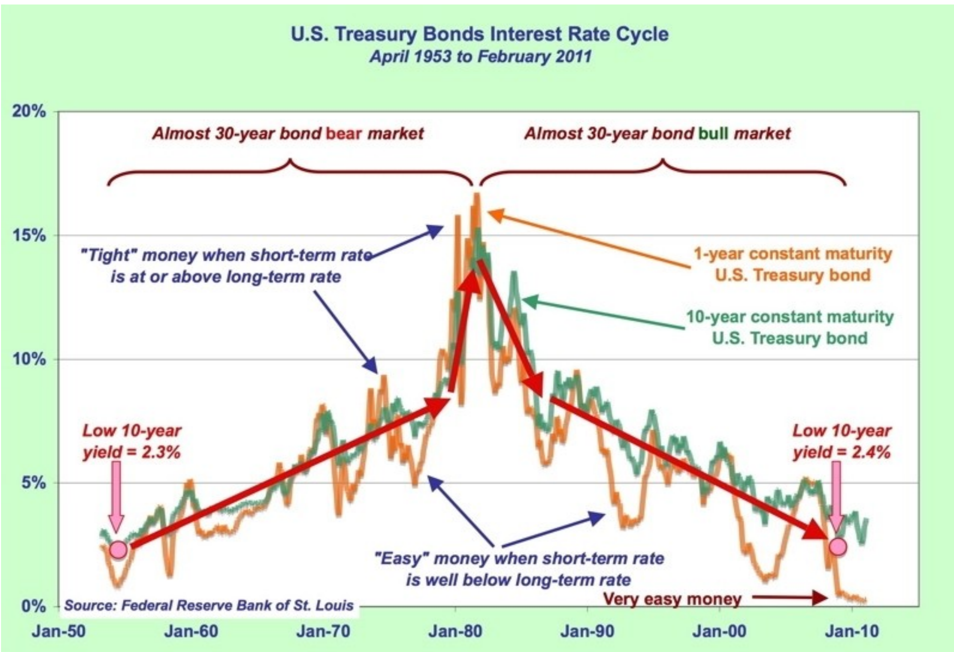



Source: Dundee Wealth Economics

This situation could be punitive to the economic recovery, already been shaken by the natural disasters in Japan. The government and the Fed could, as a result, extend QE2 and artificially maintain low interest rates in order to ensure that real estate prices remain on firmer grounds. It is imperative that consumption remain strong enough to restore investor confidence at the corporate level so that unemployment continues to contract and more disposable income finds its way back in consumption. This positive spin, one that feeds on itself, is what the Fed is trying to achieve. Its cost is larger deficits, rising sovereign debt, higher inflation  which, ironically, leads to higher interest rates.

Recently, Bill Gross, the famed portfolio manager who runs PIMCO, the largest bond fund in the world with over $250 billion in assets, has sold all (100%) of his US Treasury holdings. His reasoning is that they offer too low a yield for the maturity risk. In other words, he doesn't feel the coupon rate is high enough in relationship with the term. He also feels that the two Fed programs (namely abnormally low interest rates and QE2) have skewed US Government security flows and pricing. These actions have more than likely increased the risk of an adverse, meaning up, move in yields, while pricing drops (chart 4).

**Chart 4**




Source: Pimco

His concerns are not to be ignored. After 30 years of a downward trending interest rate environment combined with the unprecedented Government and Fed efforts to inflate the economy, interest rates are bound to move up eventually. The question is not if but when.

In this environment, investment decisions are difficult given our depleted purchasing power, the result of inflation and the low return on secure investments.

**Conclusion & Investment strategy**

When we look at all the key elements together, we can eliminate exposure to the most obvious risks. Consider the following:

1. Quantitative easing = devaluation of US dollar
2. Hard assets inflate (i.e. commodities) as they counter-react to the decreasing value of the US dollar
3. Inflation is the Fed's solution to fight deflationary pressures caused by the financial crisis.
4. Artificially low interest rates cannot be maintained forever. However, the longer they remain low, the higher they will rebound.
5. China has been the largest seller of US treasuries over the past year and a half, as the US dollar continued to devalue. Accordingly, they are now stockpiling commodities.

In an environment where the US dollar continues to devalue, I believe in avoiding US stocks that rely completely on domestic sales or very little on exports. The key to offsetting the downward pressure on the US currency is to invest in a large cap US companies that generate at least half of their sales outside the US. A drop in the US dollar is reflected positively on foreign sales revenues. However, a country with a stronger currency will not suffer as strong inflationary pressures since a stronger currency partly compensates for the higher cost of foreign goods (such is the case for Canada). We would therefore prefer to invest in parts of the world where the currencies are stronger. Emerging markets correspond to such group and they benefit as well from much lower debt levels. Some even enjoy a trade surplus.

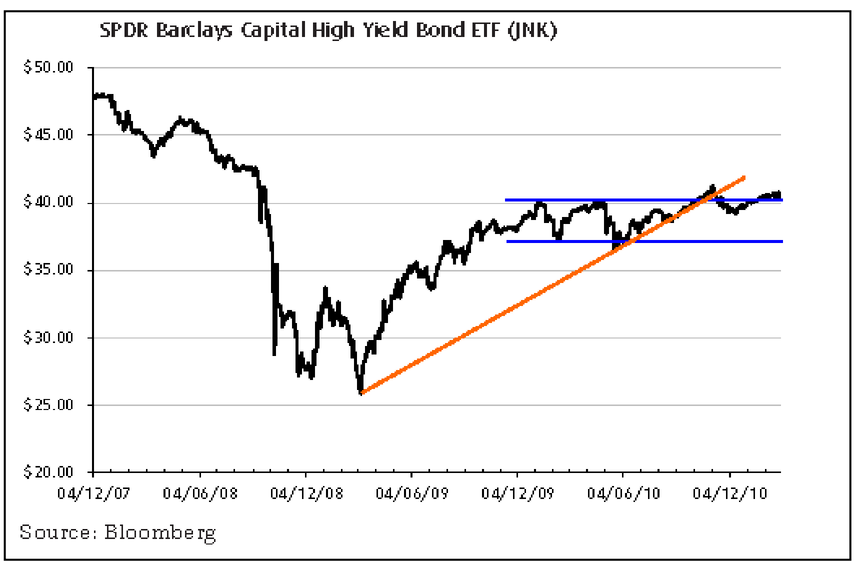
If we believe that interest rates will edge up sooner or later, then a nearly debt-free company may become a better alternative than riskier leveraged companies that have outperformed in the past. Greed may no longer be in style when interest rates start a new 30-year cycle (see chart 4).

This would affect your fixed income strategy as well. One would not like being caught holding the bag of a bond portfolio with a long maturity at this junction. A laddered, shorter term duration, although offering a lower coupon rate, remains your safest bet to protect against higher interest rates and highly volatile stock markets.

Furthermore, the simple fact that most portfolios today are more exposed to commodities than at any time in the last 25 years suggests a larger volatility factor, and should be offset by a significant fixed income component, in line with your risk tolerance level. Needless to say commodities remain an essential part of your investment strategy as they will help you maintain or protect your purchasing power. Although many investors feel safer having all of their capital in guaranteed certificates, the unfortunate reality is that their capital will buy them much less in the future. Alternatively, those investors overly aggressive in commodities may not be granted the time to adjust their holdings when China, or any other emerging market, announces some measures that may stunt economic growth or huge stockpiles of commodities and a strong rise in inventory levels causing panic selling.

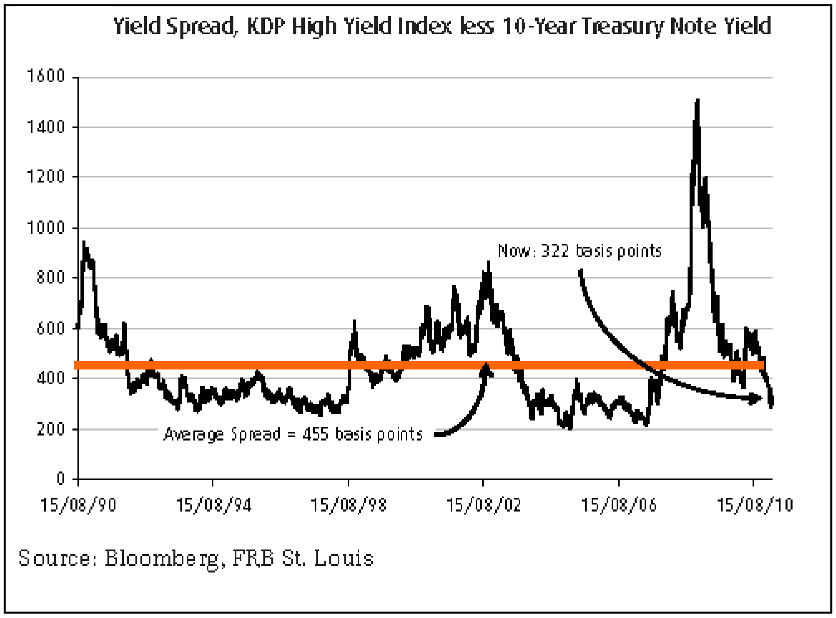
The Warren Buffetts and Bill Grosses of the world can give us a good indication as to where to go or not go. Mr. Buffett has been on a buying spree since the financial crisis. He looks for world-class businesses with low debt levels and strong cash flows. He made his enormous fortune by investing in exactly that way i.e. holding fine companies, which have proven track records and competent management, over the long term. He says his favourite holding period is “forever”. He would only sell some stock to reduce his weighting or when signs of irreversible trouble arise. As for Bill Gross, the bond specialist, he no longer owns pure US Treasury bonds. He has replaced the maturity risk with growth potential through high quality corporate bonds and other structured investment vehicles that provide him a larger return relative to growth risk. In other words, he feels the risk is smaller in the growth potential than the risk of having a rising interest rate environment. As for our exposure to longer term bonds specifically, we don’t have any. However, we are overweight in utilities (electricity and pipelines) which react in a very similar way to long-term bonds as they pay a stable and sustainable dividend. They have increased in price substantially in the last three years as interest rates were compressed similar to high-yield bonds (see chart 5-6).

**Chart 5**




Source: BMO Capital Markets

**Chart 6**




Source: BMO Capital Markets

Those gains will disappear when rates resume their uptrend, although their distributions may not be at risk. We recommend a 10% weight for now, but we may reduce our exposure in due course although we know it will be a tough sell as investors have fallen in love with these stocks.

Last but not least, the S&P 500, which has outperformed emerging markets in the past twelve months, may not be able to maintain that pace over the next quarters as earnings comparables year-over-year may be more difficult to come by, given the sharp rise in commodity and energy costs. This phenomenon may result in a shift back to emerging markets in the near future, which would allow for better performance abroad.

Our holdings in energy remain at about 10-12%, and we favour income generating stocks, as it is the only inflation-sensitive industry where we can find yield. Gold at a 5% weight, base metals at 4%, and agriculture at 4%, round out our materials sector, that is inflation-sensitive as well.

The financial sector, namely banks, insurance and real estate, stands at roughly at 15-17%. We feel, however, that a rising interest rate environment is not favourable to the industry. As we don't expect rates to move up sharply in Canada over the short-term and since Canadian banks are extremely well capitalized, we are comfortable with those weightings.  Over the short-term, however, we believe mutual fund companies may be best positioned for stronger earnings growth as the shift from money market funds towards balanced and equity funds accelerates. Power Corp (via Investors Group) may be one of the best positioned to capitalize on that front. Consumer staples at 4%, Industrials at 6-8% and Telecoms 4-6% are all within our comfort zone.

The late Sir John Templeton, a legend in the investment community, once said: “Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell.”

## RECOMMENDED ASSET MIX

| INCOME PORTFOLIO | | | BALANCED PORTFOLIO | |
|---|---|---|---|---|
| Oct 2010 | Apr 2011 | | Oct 2010 | Apr 2011 |
| 15% | 15% | CASH (CSB, QSB, T-BILLS) | 10% | 5% |
| 50% | 50% | FIXED INCOME (BONDS) | 30% | 35% |
| 15% | 15% | CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES | 15% | 15% |
| 15% | 15% | EQUITIES | 35% | 35% |
| 5% | 5% | FOREIGN | 10% | 10% |

## Sources:

Canadian Equities Guided Portfolio – March 2011
US Equities Guided Portfolio – March 2011
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Basic Points
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Credit Suisse
Dundee Wealth Economics
Pimco

*Excerpts from the Canadian and/or US Equities Guided Portfolio, March 2011

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