BMO NESBITT BURNS

Morin Dupont & Associates

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(Excerpt)

Reminiscing

1501 McGill College, Suite 3000, Montreal, Quebec, H3A 3M8
(514) 282-5828 or 1-800-363-6732
www.morindupont.com

Table of Contents

- ❖ The Economy and review of the Markets
  - o Pierre's comments
  - o Conclusion

- ❖ Recommended Asset Mix
  - o Balanced Portfolio
  - o Income Portfolio

- ❖ Review and Analysis of Model Portfolio

  Income generating investments (table)

  Canadian equities and sector selections
  1. Consumer staples
  2. Energy (Oil and Gas)
  3. Financials, Real Estate and management companies
  4. Industrials, Transportation (rails) and Engineering
  5. Basic materials and other resources
  6. Information and Communication technology
  7. Utilities and pipelines

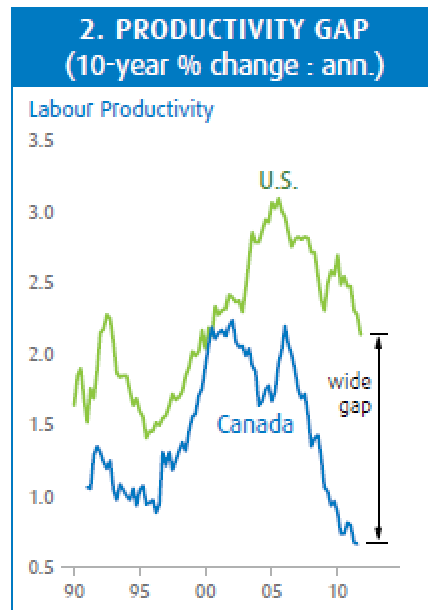
  US Equities
  1. Health, Consumer staples and Consumer discretionary
  2. Information technology
  3. Industrials

  On the radar

- ❖ Tables and Charts
  Historical performances and benchmarks

Remember 1997? Back in 1997, the TSX was hovering around 6000, the Dow Jones stood at 7000, 5-year fixed mortgage rates were around 7%, and the Canadian dollar had been re-baptized the Canadian “peso” and was trading at 72 cents against the US greenback. While Jean Chrétien’s Canada was digging out of its debt burden with the help of Finance Minister Paul Martin, US President Bill Clinton was dealing with a sex scandal, with his popularity rating dropping faster than his pants. To make things easier for both leaders, 1998 brought to life an Asian financial crisis that had a devastating effect on the West’s efforts to regain momentum. And yet, 1998 turned out to be the best entry point for both the US and the Canadian markets. Bill Clinton was able to turn his fortunes around by implementing new fiscal policies and tackling the deficit, and generated a $400 billion surplus in a growing economy in his last year in office (year 2000). Meanwhile, Canada’s “dynamic duo” was on the verge of eliminating the country’s deficit for 10 consecutive years, reducing debt significantly and setting the stage for outperforming most international stock markets over the next decade. The paradox is that it was the Liberals who cut spending and reduced the debt of this country, driving the Canadian dollar up and attracting foreign investments. In 1997, it was Paul Martin’s fiscal initiatives that drove us to sell four out of five of the US stocks we held in the model portfolio. In retrospect, we were a year too early to do so, as the US market outperformed the Canadian one by a wide margin and the loonie fell further, hitting at 63 cents in 1998. In 1999, however, the Canadian dollar finally started to rise again, climbing from that low of 63 cents to where it is today. Many economists and currency specialists had been predicting a 50 cent dollar, remember? Bear in mind that at 63 cents, it would cost Canadians nearly $1.60 to buy one US dollar – a 60% premium – which also means that US stocks, for Canadian investors, came at a 60% premium! It becomes quite difficult to outperform when you have to give up 60%, right off the bat…Sure enough, against all odds, the loonie climbed back up to reach parity within the next 10 years. But now that the dollar is at par with the US$, how sustainable is it? Can we still compete? We could if we were as productive as they are but, unfortunately, we’re not (chart 1).

Chart 1- Productivity Chart



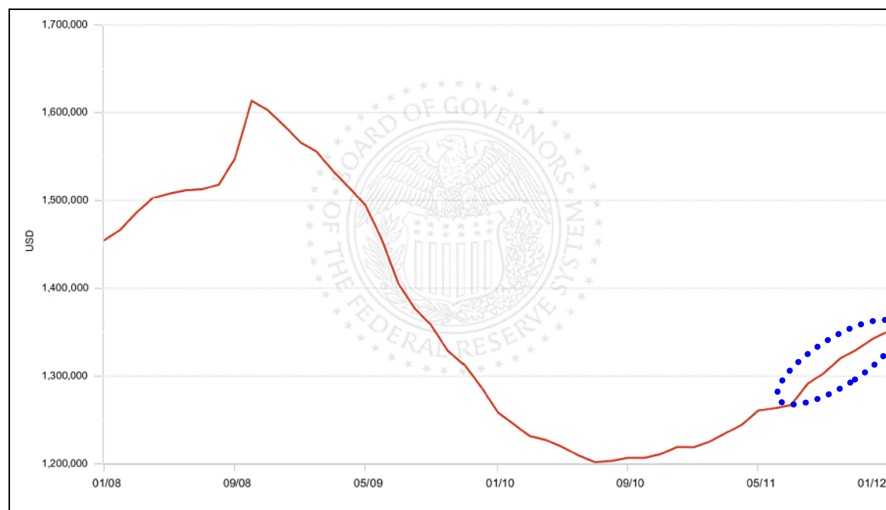
Source: BMO Capital Markets

Back then, we didn't have to be productive, we had the currency edge on our side. This is one reason why US companies opened manufacturing plants here in Canada, because we were just like a third world country to them, albeit with cheaper transportation costs, and high quality labor. Is that still true today? With unemployment at 8.3% in the US, quality labor is readily available. And with the dollar at par, the discount has evaporated. Add to that oil prices at $106.00 a barrel and one can see why cocooning seems to be back in style in the US.

As US companies continue to be earnings-driven, and given the weakness of consumer disposable income, cutting costs, consolidating operations, and investing in technology to increase efficiency and productivity, has become the name of the game south of the border. That is why many US companies have closed or reduced Canadian operations recently, and this trend is likely to continue. Electrolux, Olymel, Mabe, La Senza and Aveos are signs of things to come. As a result, Canadian economic numbers, will more than likely underperform US results, and over time, this should negatively impact our Canadian currency as compared to the US. In fact, both BMO Nesbitt Burns and the Bank of Canada predict a slower GDP growth in Canada compared to the US for 2012 and 2013 for the first time in a decade. Although I believe a slipping Canadian dollar is unavoidable, it may take time for the trend to establish itself. Nevertheless, looking three to five years out from now, I believe a Canadian dollar at par with the US dollar is unsustainable. However, it is true that our stronger Canadian Banking system combined with one of the last standing AAA rated government bonds and relatively high commodity prices are all supportive of a strong Canadian dollar. So maybe, like in 1997, I'm a year too early with my predictions, but I also happen to believe that we are all underestimating the potential of the US to lead the world out of recession and surprising us with the strength of its recovery and its markets.

As you know, the two pillars of a consumer-based economy are its banking system and real estate. Banks must lend to be in business, and lending activity is finally accelerating in the US (see chart 2)

Chart 2- U.S. Commercial and Industrial Loan Growth, 2008–2012



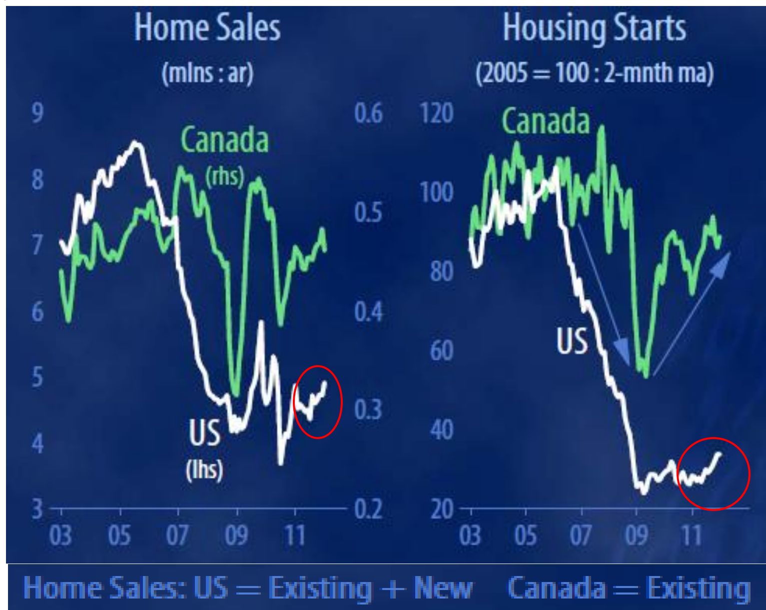
Source: BMO Capital Markets

Banks pick up the spread between their cost of borrowing from the Central Bank (currently at nearly 0%) and their lending rate. They also use their deposits – on which they pay a ridiculously low interest rate – to lend back at a multiple. The artificially low Fed fund rate is there to help chartered banks rebuild their financial base and stimulate consumer confidence. This has been Ben Bernanke's bet. The Central Bank also intervened by implementing two series of "Quantitative Easing" measures (also known as QE1 and QE2) followed by "Operation Twist" to help banks write off bad loans and reduce delinquencies significantly. For instance, through Operation Twist, 30-year fixed mortgage rates now stand at 3.75% in the US. Many US households, who were unable to make their monthly mortgage payments and were forced to put their house up for sale, can now refinance at a fixed rate of 3.75% for 30 years and keep their house. The impact is felt in the reduction in residential inventories, which will help stabilize the real estate market and eventually move prices higher. Most US banks are sitting on huge foreclosed residential real estate portfolios that are costing an arm and a leg to maintain. In addition to paying municipal taxes on these properties, they have to cover heating costs, maintenance and all the associated administrative costs. A 3.75% fixed 30-year mortgage rate may help in moving those costly portfolios from the bank level to third parties, at a discount, which would enhance the banks' financial position and strengthen the residential real estate market. Although this would trigger another major write-off for the banks, it would clear the way for a fresh start. As for the third party buyers, they could quickly reduce the real estate inventory overhang given the negotiated discount to purchase all the distressed real estate assets. These actions would be the direct result of a successful "Operation Twist". This would not only strengthen the banking system but it would bring back investor confidence and enhance consumer confidence as well, as their main asset (real estate) would be growing in value once again. As confidence builds, corporations might feel more comfortable with hiring, investing in new equipment and building inventories. Such a reversal, however, is only achievable if both pillars – banks and real estate – are back on a strong footing. The stage is set for realizing this potential and launching a positive spiral that would feed upon itself. The end result is more jobs, more growth and therefore more tax revenues for the government. Only then can we start talking about deficit reduction and perhaps some austerity measures, although those are always a tough sale in the States.

Operation Twist was not very well received by financial markets when it was introduced in August last year, as it was not perceived to be a short-term fix, as QE1 and QE2 were. However, it offered the potential of strengthening the foundation on which our two pillars rest, which will have a much longer lasting effect on confidence and, hence, the economy.

Chart 3 shows improvement in real estate indicators in the last few quarters, very modest but nevertheless headed in the right direction.

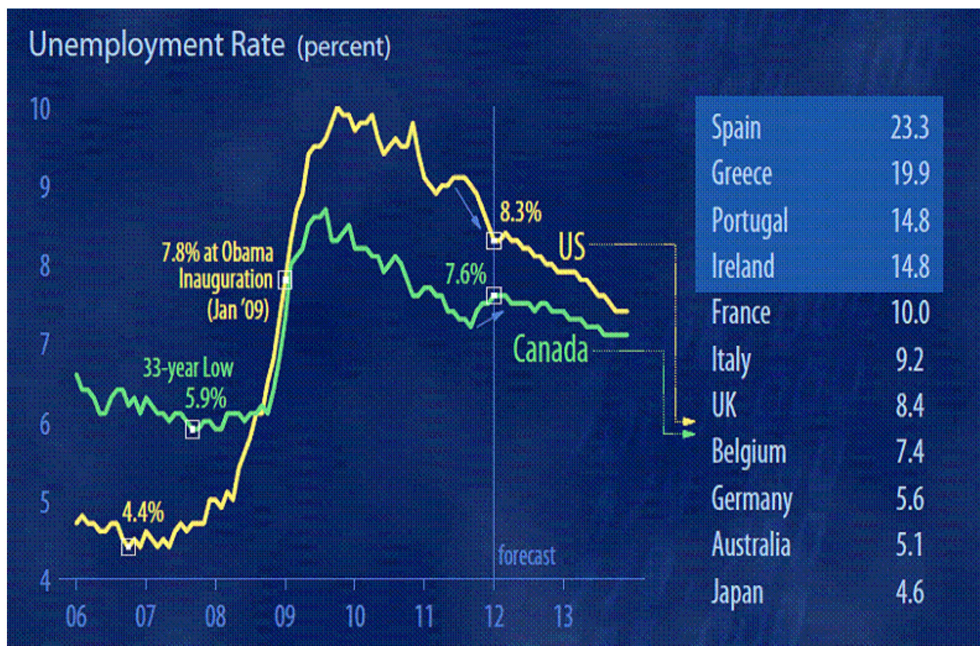
Chart 3



Source: BMO Capital Markets

Unemployment is also showing signs of improvement (chart 4), and US banks responded very well to the March 14th stress tests imposed by the Central Bank, following which 15 of the 19 major US banks were given the green light to increase dividends or reinstate share buybacks.

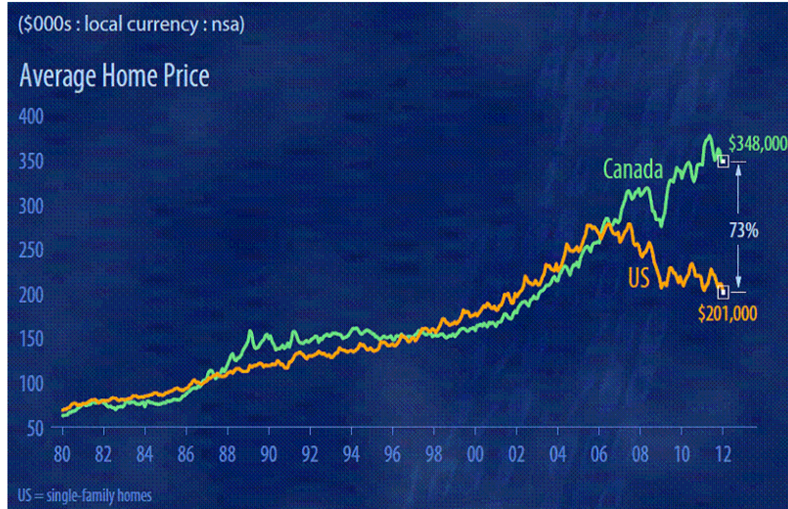
Chart 4



Source: BMO Capital Markets

Although it's still very early in the game, these are all positive signals for the US economy. Chart 5 shows how wide the gap is between average prices for a house in Canada vs. the US.

Chart 5



Source: BMO Capital Markets

Where do you think we find the better value? If you think longer term, the answer seems obvious. But what about stocks? Are they as cheap as real estate seems to be? Perhaps not, but based on historical data, they are indeed cheap. Chart 6 shows the relative price of US stocks as a multiple of their earnings on a per share basis (price/earnings ratio) over the past two decades.

Chart 6

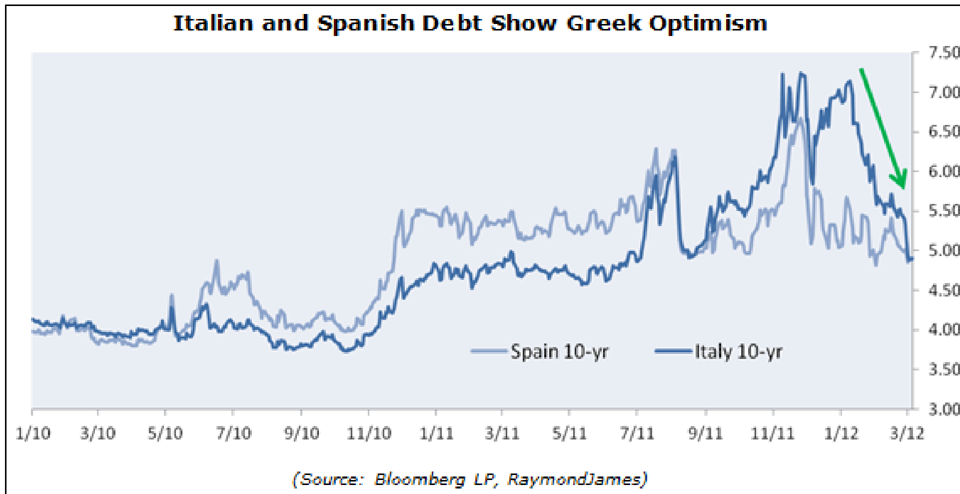
Source: Bloomberg

In fact, the average P/E ratio in the US over the past 35 years has been around 17 to 18 times. Today, the S&P500 is at roughly 13 times. Meanwhile, as mentioned in our last newsletter, US corporations have never been in better financial shape. Many have reduced their debt significantly and have raised cash while waiting for opportunities. The US government would love to see them invest more actively, but smart managers first want to see consumers in better financial shape as well. The Fed is trying hard to accelerate the deleveraging process, with actions such as Operation Twist, but it takes time to filter through. This allows smart investors to accumulate good stocks over a longer period of time at relatively cheap prices, but they have to be patient. As for Canadian investors, there might be an additional sweetness or incentive for us… Let's use an example. Say we buy a good quality US stock that pays a predictable and sustainable dividend of 3%, with low or no debt, significant cash reserves and a growth forecast of 5% per annum, the total return to the investor could be in the vicinity of 8%, all things being equal. Let's also assume a Canadian dollar back down to, say, 90 cents three years from now (which is a big assumption). This would translate into an additional 3.3% return per year, for a total return of 11.3% per year. Now let's say the P/E multiple expands to reach the 35-year average of 17 times, your annual rate of return would exceed 20% per year. Although that's a lot of "ifs", it is easier to make money buying low, when times are tough and uncertain, than buying when everything is going well and stocks are expensive.

STUMBLING BLOCKS

We have all heard about them repeatedly over the past two years – Greece, PIGS (Portugal, Italy, Greece, Spain), the European crisis, the sovereign debt crisis, China's recession, you name it. All these issues have been or are being addressed. For sure there are risks, but that is why stocks are cheap. Europe's Central Bank, although late to address these issues, is currently boosting liquidity and stabilizing the banking system with its second intervention, injecting another €529 billion in the form of a 3-year, long-term refinancing operation (LTRO). This action eliminates the possibility of a short-term disorderly default by Greece and strengthens the banking system in the region. Delaying a Greek default helps in solidifying a defense mechanism to avoid a contagion effect later on. I personally believe Greece would be better off in the long run out of the European Union, with a weaker currency but with stronger fiscal policies and controls. This would attract foreign manufacturing investments. Of late, bond markets have been very favorable towards Italy and Spain in view of the ECB's most recent interventions, pushing bond yields much lower (see chart 7).

Chart 7



In the US, the debt ceiling issue will be back in the news before the next newsletter, as Republicans and Democrats fight for the same result using different weapons. In the end, though, expect to see some compromise from both sides, resulting in a better environment, from both an economic and an ecological standpoint. Indeed, there is an unprecedented amount of cash available (thanks to the soft monetary policies put in place to avoid deflation or a depression) to invest in all kinds of infrastructure and development projects and lead the world out of recession.

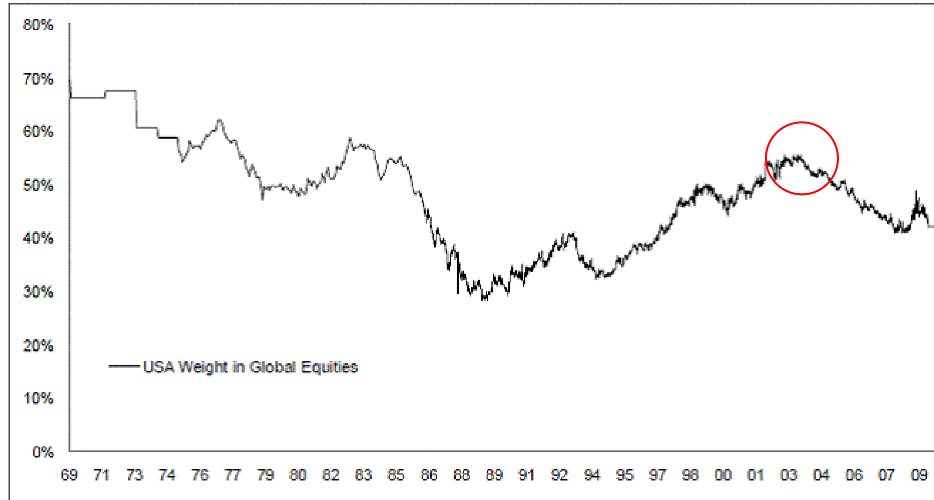
Last but not least, rising energy costs could drive the recovery off its tracks. This is why the situation with Iran is so critical. Saudi Arabia's decision to compensate for Iran's embargo will help in the short-term, but we all know that rather than looking at the supply side of things, the US should be looking towards alternative energies. Natural gas is so abundant in the US that the price has reached its lowest level in 15 years at $2.25. As previously mentioned in past newsletters, the conversion of eight million trucks (18-wheelers) from diesel to natural gas would reduce US dependence on oil imports by 60%, which would help ease prices and support the consumer-driven economy. Although this might not be the best of news for Canadian oil producers, it would help gas producers. A balanced exposure in both would therefore appear not only advisable but necessary.

CONCLUSION

In light of improving economic indicators and attractive valuations, we are positive about the market outlook for the next three to five years. However, as always, major hurdles exists, but we believe that there should be sufficient time to prepare for them, allowing the central banks and governments to be better equipped to meet these challenges, both in the US and in Europe. As the US has been a leader in recapitalizing its banking system starting way back in 2008, the country is well positioned to emerge from the recession and seize opportunities ahead of others. Back in 2000 and in 2004, I had used the US weighting in the MSCI Index (Morgan Stanley International Index) as a momentum guide, as explained in the relevant newsletters. Early in the new millennium,

the US weighting had reached a record of nearly 56% of the world's total savings (Chart 8).

Chart 8

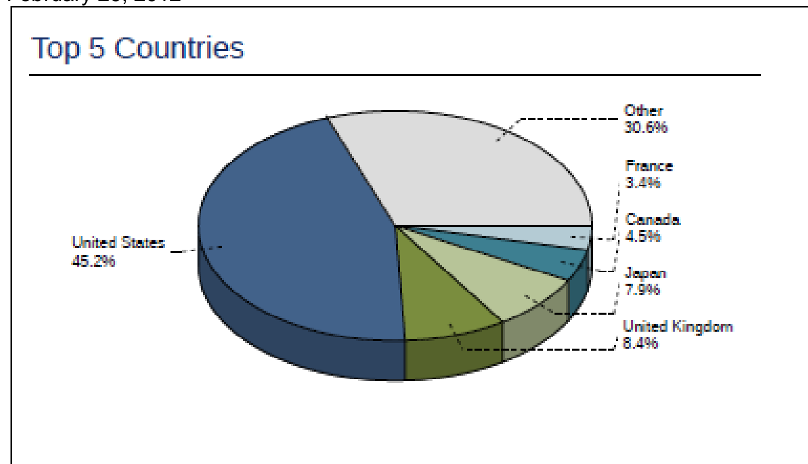


Source: MSCI Barra. The USA weight represents the market capitalization weight of the MSCI USA Index in the MSCI World Index until 1987, and its weight in the MSCI ACWI Index since then.

By the end of 2010, that weighting had fallen to approximately 41.4%, nearing a 15-year low. As of February 2012, the US weighting had inched up to 45.2% and is probably working its way back (chart 9).

Chart 9

February 29, 2012



Source: MSCI Barra

The argument here is that, as the US leads the world out of recession, with attractively valued equity markets and unattractive bond yields, the world's huge excess liquidities will no doubt be in search of a better place to invest… According to the US Federal Reserve Flow of Funds data, the US liquidities currently are US$1.3trillion (domestic and foreign checkable deposits and savings deposits) and according to Statistics Canada Financial Statistics for Enterprises, Canadian liquidities currently are

$259billion (Canadian and foreign currency and deposits). US equity markets will likely be the destination of choice for many, worldwide. The combination of these excess liquidities and the potential for fixed income assets to be partly reallocated towards equities could be extremely favorable for boosting stock prices and P/E multiples. As Canadians, many of our companies benefit from either US or emerging market expansion. But some sectors or industries are not well represented in Canada, which limits our choice. We feel, however, that the time is right to expand our model portfolio into US stocks that are complementary to our Canadian exposure, especially now that our Canadian dollar is at par. Last year, we introduced two US stocks in the healthcare and technology industries. We added two more recently in consumer staples and materials. We are looking to introduce one telecommunication stock and either an industrial or a bank stock as well in the near future. Currently, we feel comfortable with a 15 to 17% weight in the financial services industry, with a somewhat reduced exposure in real estate to 5% in favour of insurance stocks, while keeping bank stocks neutral for the moment. Our exposure to utilities is bound to be reduced in months to come to under 10%.

Although we are maintaining our exposure in energy at roughly 10%, we are making sure everyone has at least a 3% exposure to natural gas. Our telecom exposure might increase slightly with the introduction of one US stock, but shouldn't exceed 7%. As for materials, we are maintaining our 5% exposure to gold with an exposure to base metals, although giving a preference to agriculture. Total exposure to materials should hover around 10%. While industrials, including transportation, remain at about 8%, all other industries such as consumer staples and discretionary, technology and healthcare, are all standing at less than 5%.

As we are entering our 30th year in the industry, it seems that reminiscing is becoming a more frequent reflex in many situations. Hopefully, it will serve us well going forward.

RECOMMENDED ASSET MIX

INCOME PORTFOLIO			BALANCED PORTFOLIO	
Oct 2011	Apr 2012		Oct 2011	Apr 2012
20%	15%	CASH (CSB, QSB, T-BILLS)	15%	10%
50%	50%	FIXED INCOME (BONDS)	35%	35%
15%	15%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	15%	15%
10%	10%	EQUITIES	25%	25%
5%	10%	FOREIGN	10%	15%

Disclaimer: Subject to an evaluation of the risk profile of individual clients

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*Excerpts from the Canadian Equities Guided Portfolio, March 2012

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