MID-SUMMER 2011 NEWSLETTER

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Newsletter by Email

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Normally I write newsletters at the end of each quarter, but due to the recent market correction and volatility I think that it is useful to give you a snap shot of what has happened to the markets recently.

	52-Week High	August 12 Close	% Decline
S&P 500	1,370	1,178	(14.0%)
TSX 300	14,329	12,542	(12.5%)

Needless to say, this correction, combined with very high volatility, has created considerable investor anxiety.

Canadian T-Bills and Bonds

	March 31/11	June 30/11	Aug 12/11
90 day	0.93%	0.91%	0.82%
180 day	1.10%	1.01%	0.88%
1 year	1.35%	1.18%	0.88%
2 year	1.83%	1.59%	0.93%
5 year	2.78%	2.33%	1.53%
10 year	3.37%	3.11%	2.45%
30 year	3.77%	3.54%	3.09%

U.S. T-Bills and Bonds

	March 31/11	June 30/11	Aug 12/11
90 Day	0.06%	0.015%	0.015%
180 Day	0.155%	0.10%	0.07%
1 year	0.23%	0.19%	0.10%
2 year	0.80%	0.48%	0.20%
5 year	2.25%	1.78%	0.96%
10 year	3.44%	3.18%	2.26%
30 year	4.48%	4.39%	3.72%

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Ironically, investors who purchased 10-year Canada bonds in March @ 3.37% made a very good return due to the bonds appreciation after rates fell. That being said, it's hard for me to see good value in a 5-year Canada bond yielding 1.53% or a 10 year Canada bond yielding 2.45%

Why Are Things So Crazy?

The challenge of many of the western democracies is that in order to get elected, politicians had to promise to cut taxes while fighting expensive wars and continuing to provide increasing levels of services.

In addition, longer life expectancies and aging demographics have increased the costs of old age security benefits far in excess of levels originally budgeted. A number of countries have lost the confidence of the bond markets and can now only raise funds at prohibitive rates.

10-Year Government Bond Yields August 12, 2011	
Japan	1.05%
U.S.	2.26%
Germany	2.33%
Canada	2.45%
U.K.	2.53%
France	2.98%
Spain	5.00%
Italy	5.02%
Ireland	9.83%
Portugal	10.39%
Greece	15.53%

Clearly the last three countries have effectively lost sovereignty of their fiscal policies, and now have to negotiate with lenders to run their budgets. Countries in this situation are almost in a no win situation because bond investors want higher yields for the extra risk, adding to the deficit, and the necessary austerity measures contract the economy.

Italy and Spain are in the "penalty box", and their leaders will have to make painful decisions to improve their finances so that their voters continue to have control over fiscal choices.

While Japan, the U.S., Canada, and Germany continue to have the support of the bond markets, the equity markets are signaling that some changes have to be made.

The U.S. has a well-known deficit and debt problem. While some politicians continue to promise painless (to their own base) solutions, some combination of tax increases and spending cuts are necessary to ensure that they don't find themselves paying punitive interest rates.

Austerity budgets are necessary and beneficial in the long run (Canada did this in the 90's), but they are contractionary to the economy in the short term and toxic politically (remember the advent of the GST!)

While reasonable people can disagree as to what combination of tax increases and spending cuts countries must take, I don't think that as investors we can afford to ignore the world's federal budgets changing from stimulative to contractionary.

What Should We Do In A Slow Growth World?

1) Don't panic. Last week U.S. investors withdrew $3.5 billion net from global equity funds. This is the largest withdrawal since the second week of October 2008. The October 17, 2008 TSX close was 9,562, now it is 12,542; the market is up 31% (not including dividends) during the following 2 year and 10 month period.

   U.S. investors pulled $11.5 billion from U.S. equity funds last week, the most since May of 2010. If they sold mid-May last year when the S&P 500 was around 1,100, they missed a 22% one year return.

   Corporate directors and officers are currently making large insider buys. While insiders are not perfect investors, I suspect that they do better than the typical mutual fund investor.

   Corporations are finding assets attractive at current levels. Recently TD Bank has purchased Bank of America's Canadian MBNA credit card portfolio. Google has offered to buy Motorola Mobility for U.S. $12.5 billion. These two corporate deals show that companies have confidence in their own businesses.

   Despite the weak economic backdrop, 76% of U.S. corporations in the S&P 500 index exceeded earnings estimates and Q2/11 earnings grew at 12% year over year.

2) Don't be a hero. While equity markets look very attractive now, and I would encourage investors to add quality equity positions, it is important to stay true to your risk tolerance with appropriate asset allocation.

During the spring many of you took profits on Algonquin Power and Northland Power debentures, and took losses on "dogs" in your portfolio. In my April newsletter I mentioned that it was a good time to be "patient" with your money market funds.

Now is probably a good time to start re-investing, perhaps with 3 or 4 purchases a week or two apart.

3) Everyone has different risk tolerance and none of my clients' portfolios are exactly the same. Here are some medium risk common shares that look good at current prices:

	Trailing P/E	Dividend Yield	% Off 52 Week High
Royal Bank	13.29	4.22%	(16.8%)
National Bank	11.19	3.87%	(10.4%)
Power Financial	12.04	5.21%	(16.0%)
Manulife	10.72	3.94%	(31.6%)
CN Rail	14.40	1.83%	(9.08%)
Brookfield Asset Management	11.39	1.74%	(13.2%)
Genivar	9.53	6.03%	(28.0%)
Suncor	12.96	1.38%	(32.5%)

Investors now have a great choice of high quality companies trading at attractive valuations. The list above looks attractive, but many other stocks look cheap as well.

4) Bonds and preferred shares have performed well during the equity correction, but there are still 4 ½ year corporate bonds with 5%+ yields (Vermilion Energy), and a number of quality preferred shares yield between 4 and 5%.

5) Don't forget the dividend tax credit! The following are the various tax rates for dividends and interest income. This makes a difference in taxable accounts.

British Columbia (BC) Combined Federal & Provincial Tax Rates				
	2011 Marginal Tax Rates			
			Canadian Dividends	
2011 Taxable Income	Other Income	Capital Gains	Eligible Dividends	Small Business Dividends
First $36,146	20.06%	10.03%	-9.42%	4.16%
Over $36,146 up to $41,544	22.70%	11.35%	-5.70%	7.46%
Over $41,544 up to $72,293	29.70%	14.85%	4.17%	16.21%
Over $72,293 up to $83,001	32.50%	16.25%	8.12%	19.71%
Over $83,001 up to $83,088	34.29%	17.15%	10.64%	21.95%
Over $83,088 up to $100,787	38.29%	19.15%	16.28%	26.95%
Over $100,787 up to $128,800	40.70%	20.35%	19.68%	29.96%
Over $128,800	43.70%	21.85%	23.91%	33.71%
Marginal tax rate for dividends is a % of actual dividends received (not grossed-up amount).				
BC Basic Personal Amount				
2011		Tax Rate		
$11,088		5.06%		
Federal Basic Personal Amount				
2011		Tax Rate		
$10,527		15.00%		

Source: http://www.taxtips.ca

Summary

While the last few months have been disappointing and challenging, the markets seem to have already discounted a very negative outlook. I feel that the investors who gradually increase their equity holdings within their risk tolerance will come out ahead over the next 12 to 18 months. If you have any questions, please call.

All the best!

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