RBC Dominion Securities Inc.

MONEY NEVER SLEEPS

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GET INTO THE ZONE (EUROPE FINALLY TURNING THE CORNER?)

"Happy is he who owes nothing." - Ancient Roman Proverb

One of the Wall Street axioms I learned early in my career was "don't fight the fed." Think about it: if the most powerful control bank in the world wants to cool an overheated economy and reduce the risk of inflation, it raises rates. If it thinks the economy is not growing quick enough, it lowers rates to stimulate. Seems simple and makes sense—who am I to argue?

Well, it would then seem fair to assume that applying that logic across the board to other central banks would have the same application, no? The most recent "crisis" was in Europe in 2010-2011 and it sent markets all over the globe into a spin. So one has to ask the following question: Is it time to take another look at the eurozone markets?

Last week, the European Central Bank (ECB) created a "negative" interest rate of 0.1% annually on bank reserves. In other words, banks must now pay the ECB to hold excess reserves. What the ECB is trying to do is get its member banks to get the dollars into circulation, be it in the form of lending, investments, etc.—all of which help the economies and give banks an incentive to lend. In 2012, European bank loans fell by 0.6%. In 2013, they fell 2.3% and ending April 2014, 2.5%. These numbers are not good and show constrained credit, which is the oil for the engine of any economy, and do not fuel growth. Economies need free flowing credit to prosper. It's the lifeblood of a free market economy.

Inflation is also so low in Europe that the ECB is worried about deflation. Many analysts are highlighting the similarities with the Japanese experience from 1989 to 2009 or so.

But will it backfire? If banks are forced to pay the ECB to hold reserves, will they pass on those costs to their customers in the form of fees on deposits? That would only be an incentive for bank customers to hold more cash and fewer deposits. As economics 101 will tell you, fewer deposits leads to a shrinking money supply, which in turn causes—yep—deflation.

In other words, in trying to fight deflation, the ECB could actually cause deflation.

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Get Into the Zone
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The real problem in Europe—and one which is growing exponentially in the U.S. under the Obama administration, and right here in Ontario—has absolutely nothing to do with money. It has to do with heavy labour regulations, high tax rates, excessive/wasteful government spending, and excessive redistribution. As I see it, this is caused by political atrophy, which is causing economic atrophy.

Similar to Japan, the demographics of the European population have slowed precipitously and are even negative in many countries. This has nothing to do with money supply out of the ECB. The ECB, like the Federal Reserve in the U.S., doesn't have the authority to cut government regulation, spending or tax rates. Both of those central banks have provided lots of liquidity, but the demand for loans (driven by economic growth) is simply not there. Europe, the U.S., Japan, the world… none of these economic entities have a problem with liquidity.

It has become mainstream thinking that central bank policy, simply by imposing their will, can grow economies. The "myth" that central banks saved the world from certain disaster in 2008 has become conventional wisdom. It helped, sure, but it takes more than that.

Trying to force banks to lend is futile. They simply won't do it if they think they will lose money. And now if they do a lot of it successfully and do well profit-wise, they will only get criticized and attacked for it. If the real problems in the economies were due to a lack of liquidity, then some or all of these policies would help, but liquidity is not the problem. Money supply is growing faster than loans. Keynesian economists call this a "liquidity trap," but it is really a government-driven "fiscal policy trap."

They talk about "too big to fail" banks, but it is governments that have become too big. (For example, in Ontario, 1 in 7 is now employed by the provincial government.) In my opinion, governments tax too much, they spend too much, they regulate too much, and often distort investment incentives (for example: wind and solar power).

If the world wants faster economic growth, it needs a massive fiscal overhaul, but alas, the political will is simply not there.

Governments everywhere now seem to have this elitist attitude that they can provide basic services better than the private sector. Trying to rely only on central banks via monetary policy to fix problems caused by fiscal mistakes could only create bigger problems down the road. Negative interest rates are one example of these policies.

Narrowing back to Europe for a moment again, a few weeks ago the Italian government announced it would add the underground/shadow economy of drugs, prostitution and possibly illegal tobacco and alcohol sales into its GDP calculations. Such a move would create the ultimate stimulus as it has often been estimated the grey economy accounts for 10-15% of the nation's GDP. This move would not only be a careless answer to a very difficult problem, but would likely be raising the white flag of surrender to the ever-growing economic strength of the Mafia in that country. It is estimated they raked in 200 billion euros in 2013 from illegal operations. The violence has gotten so bad that even Pope Francis addressed the issue on March 14, 2014:

"This life that you live now won't give you pleasure. It won't give you joy or happiness. Blood-stained money, blood-stained power, you can't bring it with you to your next life. Repent. There's still time to not end up in hell, which is what awaits you if you continue on this path."

It will be interesting to see if the EU, whose rules mandate that deficits cannot exceed GDP by more than 3%, accepts Italy's new calculations, and that government debt can't exceed GDP by 60%.

In the U.S., the once black market of marijuana has now been decriminalized in many states, and will most likely now be added to the GDP calculation. The Obama administration recently added research and development, and artistic creation to the GDP calculation. This controversial move—which I disagree with—improved GDP significantly last year, but all it did was build a case for even more government borrowing and spending.

Europe certainly still has lots of issues to deal with. The "southern" parts of Italy, Spain, Portugal and Greece are still reeling. Greece is technically bankrupt, of course, but it only accounts for about 2% of Euro GDP. Germany and France have been huge beneficiaries of a lower euro. The UK (not in the EU note) has been reporting their best numbers since 2007.

Investors are starting to increase exposure to eurozone equities. To get back to fill the gap of outflows since 2007, inflows would have to be US$94 billion, which would definitely provide a nice lift (Source: Thomson Reuters Jan 31, 2014).

Valuations seem "OK" in Europe as well and seem to have considerable upside:

Place	P/E Ratio	Dividend Yield	Price/Book Ratio
Canada	18.6	2.9%	2.1%
USA	18.7	2.0%	2.9%
Europe	15.0	3.0%	1.8%
Emerging Markets	12.0	3.2%	1.7%
Japan	15.0	1.7%	1.4%
World	16.1	2.5%	2.1%

(Source: Thomson Retuers Feb 21, 2014)

When compared to the U.S., the eurozone compares well:

	EU	U.S.
Population (2012)	503.7 million	315.8 million
GDP (2011 in billion Euro)	12,638	10,830
Unemployment Rate (Dec 2013)	10.7%	6.7%
Patent Applications (2010)	54,414	24,641
Fortune 500 Companies (2013)	160	132

(Source: Thomson Reuters/Fortune Magazine)

Don't get me wrong, I still think the U.S. is *the* place to be, but it's time to give Europe a look. It looks to me like their cycle is in a four-year delay to North America, and if their central bank has just embarked on a QE-type easing, most of that capital could find its way to the equity markets, which is what we saw with the U.S. Fed.

Stay tuned,

Vito

The Little Picture (But Really the Big Picture)

On July 9, we will be hosting our annual Children's Golf Classic at Sunningdale. This year is a special year as we celebrate our 25th anniversary and RBC is the title sponsor once again. The event has raised approximately $3 million (net) over the years, 100% of which goes to our local children's hospital. A special thank you to all of our clients and friends who have been supporters of this great cause for many years.

Notes

Facts and Figures

- Warner Communications paid $25 million in 1988 for the copyright to the song "Happy Birthday."
- The Royal Canadian Mint produces 20 million coins each day (or 750 coins per second) from its Winnipeg facility. The plant has also produced more than 52 billion coins for dozens of other countries.
- The amount Canadians were expected to spend on weddings in 2013: $5.3 billion according to Weddingbells.ca 2013 annual survey. The average cost? $32,358 (up 5% from 2012) and rising as couples seek new ways to tie the knot to create an "unforgettable experience" for their guests.

Quotes

"The American Republic will endure until the day Congress discovers that it can bribe the public with the public's money."
Alexis de Tocqueville, French Political Thinker
1805-1859

"It is easy to be 'conspicuously corporate' if others are being forced to pay the cost."
American Economist/Historian Murray Rothbard
1926-1995

"The essential quality of a market system, contrary to popular thinking, is not that it promotes greed, but rather, that it renders greed harmless."
American Economist Israel Kirzner
1930-Present

"The future ain't what it used to be."
Baseball Legend Yogi Berra

"Governments never learn. Only people learn."
Economist Milton Friedman

Around the GLOBE

Canada (Buy)

- Banks have been strong, as has energy
- Time to look at commodities?

U.S. (Strong Buy)

- Plodding along at 2% GDP growth
- U.S. mid-term election in November 2014
- Fed Chair Yellen seems to be carrying on as her predecessor

Europe (Strong Buy)

- Still in rough shape, but seems to have stopped getting worse
- Is ECB embarking on its own QE program?

Asia (Hold)

- Latest data out of China shows strength
- In Japan, Abe continues to push the pedal to the metal

Emerging Markets (Hold)

- Mexico gaining traction; Latin America wobbling
- Still question mark on growth numbers

A Special Welcome to All New Clients Who Have Joined Us

Thank you especially to clients who have mentioned our name to people they know. As a sign of gratitude, four times a year we'll randomly select a client who has introduced our services to a friend for special acknowledgement via a nice dinner at one of the finer restaurants in London.

Please Don't Keep Us a Secret!

We are very happy and proud to serve clients in our practice and we are always open to serve more clients just like you. Should you be talking to someone who is unhappy with their current advisor, or would like a second opinion we would be grateful if you passed on our number 519-675-2011 or 1-800-265-5911. Thanks for keeping us in mind.

Congrats, L.S.,
Our winner this quarter!