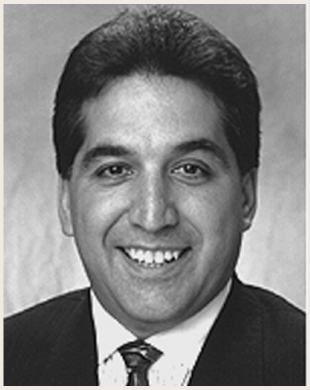
RBC Dominion Securities Inc.

Money NEVER SLEEPS

The Newsletter for the Informed Investor – www.rbcds.com/vito.finucci

JANUARY 2012



Vice-President & Director
Vito Finucci
519-675-2011
vito.finucci@rbc.com

Alyson Medeiros, CFP
Associate Advisor, Financial Planner
519-675-2505
alyson.medeiros@rbc.com

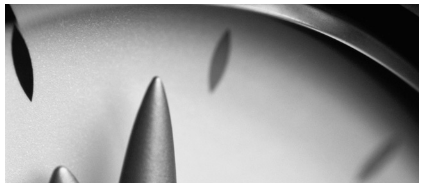
Jodie Fuller
Associate Advisor
519-675-2511
jodie.fuller@rbc.com

Jessica Restivo
Assistant
519-675-2021
jessica.restivo@rbc.com

Fax: 519-675-2020
Website: www.rbcds.com/vito.finucci

RBC Dominion Securities Inc.
148 Fullarton St., Suite 1900
London, Ontario N6A 5P3

The big Picture



"Keep Calm and Carry On"

2011: The Year Dominated by Debt

> The U.S. economy remains almost comatose. The slump already ranks as the longest period of sustained weakness since the Depression. The economy is staggering under many "structural" burdens, as opposed to familiar "cyclical" problems. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought, the debt hangover, the banking collapse, the real estate depression, the health-care cost explosion, and the runaway federal deficit.
>
> **Source: *Time Magazine*, September 1992**

The title of this month's commentary was originally attributed to Winston Churchill, as Britain prepared for World War II in September 1939. It regained profile in New York City after 9/11 when the NYC Fire Department used the phrase. It is still noticeable in the various firehalls there, as noted during my recent trip to NYC in August 2011. With two sons training to be firefighters, I've seen the phrase embossed on various items they've had. While the phrase is sage with respect to carrying on in everyday life, it is especially wise today with respect to financial markets and investing in general.

The year 2011 started on a strong note for the global economy, but as the year wore on, fears of spreading contagion from European debt derailed both the global economy, and investor confidence. Frustration was the net result. And while interest rates remained low (and headed lower), inflation was benign, and corporate earnings and balance sheets were in the best shape in decades, virtually all equity markets had negative returns for the year. One of the biggest problems was a lack of confidence in those in charge of fixing the problems, as most of these politicians worried more about being reelected than doing the right thing; none more so than in the Washington Beltway.

Debt dominated business headlines in 2011. U.S. politicians bickered over the debt ceiling, deficit reductions, and "super-committee" efforts, earning the USA an unprecedented ratings downgrade. In Europe, decades of socialist fueled borrowing turned the public purse into the public curse. The word "austerity" has never been used so much as in 2011. Dithering from Europe's leaders about how to contain the crisis from spreading from smaller Ireland, Greece and Portugal, to too-big-to-save Italy and Spain, the end of 2011 seemed to have more unanswered questions about the Euro's survival than what was there at the beginning of the year.

One group that seemed to have it together, were the central banks around the globe. Having had enough of global banks unwilling to lend to each other, the central banks of six countries, including Canada, on November 30, 2011 announced they would act together to offer unlimited and unsecured U.S. dollar loans to foreign central banks at favourable rates.

Looking back, yes 2011 was not only frustrating, but confusing as the year ended with debt higher than at the start and deflation was top of mind after inflation being the main concern to start the year, which saw commodities spike, then crash. Gold, which tends to hold values during inflation and uncertainty, peaked at $1900+ U.S. an ounce in August, only to move closer to $1,600 by year end.

And let's not forget things in 2011 which one could not predict. The major one being a devastating earthquake and tsunami in Japan which had a global impact due to supplier cut off, most notably in the auto and tech sector. The "Occupy Wall Street" protests against income disparity and corporate greed, began in lower Manhattan in September, but over weeks spread across North America, Europe and Asia.

The year was a test of fortitude as well. Just when after the 2008-09 cycle one thought financial markets couldn't get any more volatile, guess what, they proved otherwise. Such was the theme in 2011 where sentiment and market swings were not month to month or week-to-week but often from morning to afternoon on the same day! As the year wore on markets became behaviorally driven and fundamentals meant little.

Ironically, the current economic recovery is closely tracking the last two economic recoveries of 1991 and 2001. For the third recovery in a row, the current cycle has been a "slow starter" with the revival of GDP growth, job creation and confidence, compared to pre-1985 economic recoveries. And like the last two recoveries, general consensus is that the recovery is dysfunctional. However, if the current recovery continues to mimic the last two, 2012 could be a pivotal year. Not that the GDP surges, but where the mindset (leaders, business, consumers, investors) finally accepts the recovery is taking place and is sustainable. In the 1991cycle the U.S. Federal Reserve lowered rates from 6% to 3% and left it there from March 1991 to February 1994, yet the recovery began in November 2001 but then the Fed lowered rates from 2.5% to 1%, and left it there for 33 months after recovery began. Currently Fed rates have been at "zero" since the recovery began, and if they rise in the summer of 2012, (as they have announced several times) it would coincide exactly with the 1991/2001 cycles. One more note... In both 1994 and 2004 (when the Fed began to raise rates), equities' returns greatly surpassed fixed income (bond) returns. Predicting the end of the great bond bull market over the last three decades (beginning in the early 1980s) has been tough, especially the last few years. But with interest rates at zero, doesn't take much to guess the next direction (up for yields, down for prices). After lining up to buy 10-yr U.S. Treasuries at 1.80% for the last few months, contrarian thinking would suggest the next year could be bad for bonds.

The S&P 500 trades at approx. 12X 2011 earnings. With 10-yr bonds at < 2%, the last time investors saw valuations like this was the early 1950s. Over the last 50 years, the S&P 500 has averaged 15X, while the yield on 10-yr U.S. notes has averaged 6.67% for that period! With the current valuations, the markets are discounting a 2012 S&P profit of $60 a share (which is a collapse from the current real $95 per share, a 30%+ drop which seems incomprehensible). In many respects, stocks are cheaper today than at the recent cycle low in March 2009. With the Presidential election cycle looming, pessimism high, expectations low, and fear levels high, with a break or two, I believe markets could see all time highs sometime in 2012, as fundamentals finally trump fears.

We all know the bearish case; the media has drilled it daily for the past two to four years. But the bullish case is a tougher one to make in fact being out of the market is the most crowded trade at this time.

Stocks are undervalued, under-owned, and unloved. There has been a structural bias against equities since 2005 when pension funds dumped them in favour of bonds. The bond bull market began in October 1981 and could be the greatest bull market of any asset class in history. But it may also be the next crash (government bonds not corporate!).

The economy is far better than the talking heads want to admit. Remember it was the same "expert" economists who in 2005 believed things were going great, when houses being built then now sit empty. Today, job growth is happening, albeit slowly, but at a time when consumer and corporate debt is being paid down. The quality of economic growth, with the exports surging and increased investment in agriculture and energy production, is much higher now. Pretty soon good news will be hard to ignore and the doomsayers and pessimists will slowly "wake up" to these realities.

Is it going to be straight up? Of course not! The roller-coaster actions of markets in the past decade will continue as opinions swing from deflation to inflation and back. Debt deleveraging and asset price deflation leading to central bank reflation will create more volatility. Since 1998, this has played out twice; in the early 2000s with corporations and this cycle with consumers. Next I guess it will be with governments (in fact already happening in Europe, and in state and local government levels in the U.S.A.).

These deflation-reflation cycles began with the Internet bubble in the late 1990s, which brought the P/E of the S&P 500 to 48 (3X historical norm). The bubble burst, and the market declined 53% from March 2000 to October 2002. The decline was further compounded by 9/11 as well the Enron and WorldCom accounting scandals. The Fed dropped rates to 1%; markets took off in 2003 and continued until 2007.

The Housing bubble began to implode in 2005. The S&P lost 57% from October 2007 to March 2009, as deleveraging kicked in. In 2009 the Fed and Central banks responded again with lower rates and quantitative easing (QE). The S&P rallied 100% from March 2009 to May 2011.

Now, the S&P stands down 25% since spring 2011 thanks to the Euro debt crisis. Central banks made the announcement November 30. Any guesses where markets will be 18-24 months out? Higher…

So the question for 2012 will be, is it possible to fix the world?

I think the answer is yes, but will take a lot of pain, a lot of creativity, and most importantly… the political will to do so. There are recent examples in Sweden, New Zealand, and yes, Canada who lowered debt/GDP ratios out of the 1990/1991 recession. Growth can solve the debt problem, but combined with huge spending cuts and mild tax increases (in Canada's case, $7 in spending cuts for every $1 in tax increases). The party which introduced the consumption value-added GST tax (the PC's) were immediately sent packing in favour of the party who campaigned on rescinding the tax hike (the Liberals), but who never did so!

Looking at the big four pillars of the global economy (U.S.A., Europe, China and Japan), we will omit Japan since they have been in deflation for 22 years and if have any contribution, would be a bonus.

The U.S.A. is slowly improving but it is sluggish. Housing is making a muted recovery, jobs are trending (albeit slowly) in the right direction, and the consumer remains strong as indicated by retail sales. The U.S. economy is weak, but recession is unlikely.

Europe has very few positive signs, and if any optimism, it's in the fact the two largest economies (Germany and France) that seem to be moving forward. Whether Europe is technically in recession or not, really doesn't matter at this juncture. Austerity in the southern states will hurt their growth.

China has grown to be a powerful global economy. How accurate or dependable their economic numbers are is questionable, but it does seem that they are in the process of executing a soft landing, which would bode well for commodities (and Canada). China cannot save the global economy on its own, and Europe is its largest customer, but they are an important pillar and we need them as much as they need us.

In Canada's case in the mid 1990s, the political will came as a result of a bond market that refused to finance deficits any longer. Would it not appear Europe is at the point? (And as an aside, all the governments of the P.I.I.G.S. nations have recently been given the boot and the new governments have inherited the issue, so they can work to resolve it with a clear conscience).

The lesson was that the bond market created the political will. If Europe enacts a large enough U.S. style TARP program to recapitalize their banks, and/or an EU bond program to buy Italy and Spain two to three years of time, I would guess there will be a substantial relief rally. Remember economic recessions are a natural part of the process. They are all about cleansing, adjusting and resetting. They are the result of weak, overstretched, running-out-of-options governments and/or corporations. They adjust to the new reality, much like the U.S.A. is learning to live without a booming real estate market. Huge investments today are going into the power grid, alternative energy, networking, tech, transportation, medicine and healthcare, etc…one could argue it is now more diversified than just housing.

Markets will continue to overreact to short-term news. When negative sentiment is so firmly planted on the fear side of the fear/greed meter, the downside risk becomes significantly reduced. Mr. Market knows all this and figured it out in April.

We enter 2012 with an ongoing bear market in equities, yields at historic lows, and volatility still in place. I think if I had told you with the benefit of hindsight back in January all the headlines for 2011, and then told you the S&P 500 would be virtually flat after all that, you would have laughed me off. The glass is half full. The markets have priced in something far worse than a mid cycle slow down.

In the end it might not matter after all and most of this could be moot. Because those of you who follow Mayan mythology know it says the planet will be rocked in 2012 anyway. The god Gutumatz (same one who taught man the art of civilization, law, agriculture, fishing and medicine) will come out of the ocean during the End of Days. So I guess what markets do day to day mean little in the grand scheme of things?

All the best for a healthy and successful 2012.

NOTES

Who are the 1%?

(Occupations of taxpayers in the top 1% of income – *Advisor Analyst*, October 18, 2011)

Executives, managers, supervisors (Non Finance)	31%
Medical	15.7%
Financial Professionals	13.9%
Lawyers	8.4%
Computers, Engineers, Technical	4.6%

Only sector that grew during this recession? Government!

Government workers with 15 to 24 years experience have enjoyed a 25% increase in pay since 2005 vs. inflation (+9%) during same period. Civilians in government making $170,000 stood at 9 in 2005, 214 when Pres. Obama took office (January 2009) and hit 994 in June of 2011. Federal employees making $150,000+ have gone from 7,420 in 2005 to 82,034 in 2010. (*Wall Street Strategies*, November 11, 2010)

U.S. Home prices have now declined 32% on average from the peak of the housing bubble. Home prices in Las Vegas are down 58%, and 70% of all Las Vegas mortgages are now under water. In Florida 18% of all homes are sitting vacant. In the city of Detroit alone, there are more than 33,000 abandoned homes. U.S. home values have fallen an astounding $6.3 trillion since the peak and home sales are down 80% from the peak in July 2005. (U.S. Census Bureau/Mortgage Bankers Association)

But according to *Wall Street Journal* (August 24, 2011), Toronto seems immune as the condo boom continues. Buyers purchased 1,986 condos in July 2011, up 28% from July 2010. The average price (now $304,000) is up 8% - 9% per year the last five years. The Toronto area has 1,198 condo projects with 210,000 units. Approximately 40,000 additional units are under construction, with 16,000 set to go on the market in 2012.

Around the globe

Canada (Strong Buy)

SLOW & STEADY

- Combination of credit growth, job growth and high commodity prices are the ticket for ensuring ongoing economic gains – healthy banking sector and relatively low levels of debt help
- Expected GDP growth for 2012, 2.0% - 2.25%
- Best profile of G8 Nations

U.S.A. (Strong Buy)

LONG OVERDUE

- The U.S.A. is still riddled with dysfunctions and these are holding back a proper recovery
- Stage is set for a modest housing recovery
- Appears U.S. equities (esp. large cap) are cheap and government bonds are expensive with 10-yr yields below 2.0%
- GDP expectation in 2012 of 2.0%

Europe (Only Multi Nationals)

MUDDLE THROUGH ECONOMIC SCENARIO

- Risk that Europe goes badly off the rails has increased last several months but any fix will not likely be a perfect long term solution
- Eurozone looks like its descending into recession but main goal is avoidance of a major bank failure, a major sovereign default or a break up to the Eurozone
- 2012 GDP growth of 0.0%
- New EU head Draghi seems more willing to deliver monetary stimulus

Asia

SOFT OR HARD LANDING FOR CHINA?

- China's economy appears to have crested for now, but they seem to be engineering a "soft landing"
- China's GDP 2012 expectation 8.25%, Japan 2.25%
- Japan's economy recovering after tragic tsunami/earthquake in 2011
- Will a North Korea/South Korea conflict heat up after the passing of Kim Jong-il?
- Australia looks attractive, with a similar profile to Canada

Emerging Markets

STILL A SOLID LONG-TERM STORY

- EM's not immune to weaker global growth driven by deleveraging
- Average expected GDP growth in 2012 is 4% led by expanding middle classes
- As a whole EM's have 5X the population of developed markets
- In Latin America, only Brazil is of interest

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 A SECRET FROM US!

We are very happy and proud of the clients we serve 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, Jerry S. Our winner this quarter!

QUOTES

"Governments' view of the economy can be summed up in a few short phrases: If it moves, tax it; if it keeps moving, regulate it; and if it stops moving, subsidize it." President Ronald Reagan

"He has all the virtues I dislike and none of the vices I admire." Winston Churchill

"I've had a perfectly wonderful evening, but this wasn't it." Groucho Marx

"In the Universe, great acts are made up of small deeds." Lao Tzu

RBC Wealth Management
Dominion Securities