

# PPM Group | Pringle Portfolio Management Group

DISCRETIONARY PORTFOLIO MANAGEMENT

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**Integrity, Trust and Experience**

*Pringle*

PORTFOLIO MANAGEMENT GROUP

**RBC Dominion Securities Inc.**

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**Economic Commentary**

## Reality Check

Following World War II, the developed nations' economies were the engine of growth in the world. The U.S., Japan and Europe dominated the world economy. With limited competition elsewhere in the world, the western countries enjoyed increasing incomes and prosperity. Birth rates exploded in the post war and the population of workers grew steadily as the baby boomers matured. Social programs and tax laws implemented in this environment seemed appropriate given the prosperity and the fact that there were more workers than retirees. However, in the past 20 years economic and demographic forces have undermined the durability of what has come to be expected by citizens of the developed nations.

The emerging economies have grown rapidly in the past couple of decades. Just as the printing press paved the way for the industrial revolution 200 years ago, the internet is now contributing to the rapid emergence of the new world. The older economies for the first time have sharp competition in manufacturing. In the developed countries, the baby boomer generation is approaching retirement age. This demographic phenomenon, coupled with the shift of manufacturing to emerging economies, has resulted in the lack of resources to support the legal and social structures put in place in years gone by. Unfortunately, the public, lawmakers and politicians didn't see this coming, or ignored it due to the inherent difficult choices that would be required to deal with it. Instead, money was borrowed to keep the good times rolling which created a false prosperity for the past decade or so. Unlimited borrowing to maintain an untenable standard of living is irresponsible and it will burden future generations. Unfortunately, many politicians and lawmakers don't get it, and prefer to stick with the more popular policies that created the false prosperity.

The credit collapse and crisis of four years ago laid bare the illusion that credit can be created indefinitely. It led to a "reality check" and the process of more careful examination by institutional investors of the fiscal soundness of debtor countries. These investors have become impatient with countries that have been slow to implement meaningful changes that will ensure their sustainability. The first victim of impatient investors was Greece, but the markets have not stopped there, seizing on other European countries with shaky finances that require material changes.

To date the focus of investors has been the weak European financial structure, and for good reason. Unfortunately, the European Monetary Union has proven to be flawed. However, as it is the chief architect and major beneficiary of the Euro, Germany will likely feel obligated to use its resources to keep the Union intact.

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While investors are busy demanding reforms and changes of Europe, North America should not feel immune. To varying degrees, the issues there are the same here. Rather than risk the chaos and uncertainty of another financial crash, it would be wise to be proactive. Unfortunately politics is preventing this in the U.S. Although it is clearly on a financial collision course, dysfunctional politics will likely prevent any meaningful action before the 2012 elections. Ironically, in spite of its financial problems, the U.S. has benefitted from the European crisis, as funds have fled the Euro for the liquidity and “safe haven” of the U.S. dollar. Perhaps this will continue through 2012, but it is also possible that at some point before then, investors will turn their wrath on the problems and lack of action in the U.S. While Canada has relatively sound finances, a strong and solvent banking system, and steady politics, the same demographic and manufacturing issues will present challenges in the not too distant future.

It took many years for the excessive levels of debt to build up, and it will take many years to unwind. Many European banks are undercapitalized by staggering amounts and will have to raise capital, sell assets, and shrink in size to regain financial health. Reluctant to sell-off prized assets, and with the capital market unaccommodating, they have been shrinking in size by reducing the credit they make available. This shrinking of their loan books may be part of the reason that we have seen waves of selling in the equity markets.

With the financial uncertainty in Europe, deleveraging by investors, and the recessionary implications of government austerity while the private sector is weak, it is no surprise that the markets have been volatile. Further, there have clearly been concerns that the precarious European situation could spiral out of control and cause another financial seizure like the Lehman Brothers collapse in the fall of 2008.

With the market dislocation and structural changes that are required, sub-par growth is likely in the year ahead. However, the artificially low interest rates and monetary

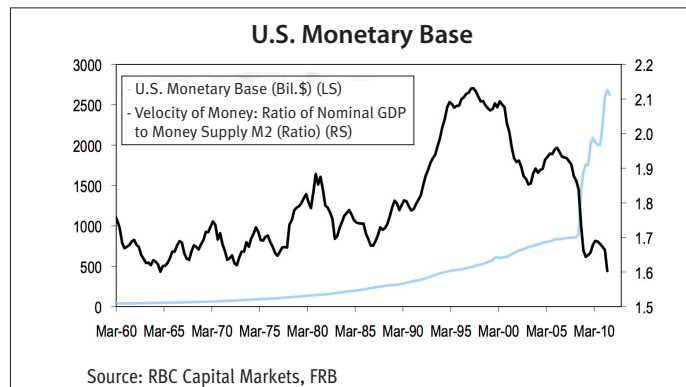
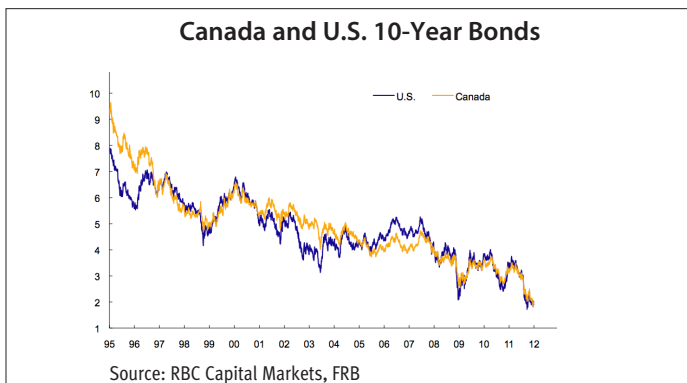
stimuli that government have implemented have kept economic growth positive to date, and in the U.S. there are even early signs of economic stability. It is quite possible that while there are serious issues to address, the markets might be too gloomy on the outlook.

It is ironic that the U.S. bond market has been a beneficiary of the financial crisis in Europe. In spite of looming financial problems in the U.S., 10-year treasury bonds yield below an understated inflation rate of 2.5%. It appears that investors have pushed yields down as they scramble and look for “safety”, and are disregarding the fundamentals for now. Yields and bond prices at today’s levels reflect panic and lack of alternatives and look to be a poor long-term investment. There is a risk that investors will turn their wrath on the policy inaction in the U.S. and trigger an exodus at some point, but this is unlikely until an alternative appears. I am wary of long-term commitments in interest-sensitive sectors because of this.

Stock markets have suffered a wild ride as investors cope with the Euro funding crisis, an uncertain economic outlook, and lack of political leadership. As we continue to work through the structural changes that are required in developed countries, it appears highly likely that governments will be forced to continue to print money to get through this crisis in a peaceful and socially responsible way. While inflation remains subdued now, the seeds are being sown for much higher inflation in the future. Several sectors of the stock market offer investors some inflation protection. Further, many large companies are in strong financial shape, are reporting record earnings and paying dividends far above bond yields.

Although volatility will likely remain, good companies with strong financials, and paying healthy dividends well above bond yields and inflation, look like a good long-term investment. I will remain vigilant and flexible in these turbulent times, and as always will do my best to protect your interests.

**Tony Pringle, CFA** | December 31, 2011



**Welcome & Thank You**  
 A warm welcome to the clients who have recently joined us, and a special thank you to the people who mentioned our name to them. We appreciate your trust and support.

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