RBC Dominion Securities Inc.

MONEY NEVER SLEEPS

THE NEWSLETTER FOR THE INFORMED INVESTOR FALL 2014

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IGNORE THE NAYSAYERS

What Causes Recessions and Kills Market Rallies?

"Capitalism is based on self-interest and self-esteem; it holds integrity and trustworthiness as cardinal virtues and makes them pay off in the marketplace, thus demanding that men survive by means of virtue, not vices. It is this superlative moral system that the welfare statists propose to improve upon by means of preventative law, snooping bureaucrats, and the chronic goad of fear." – Alan Greenspan, The Assault of Integrity

The U.S. economy is in the midst of a feeble recovery, but with a $17 trillion GDP, it has the ability to chug along and gain momentum, eventually reaching "escape velocity." But its biggest challenge, in my opinion, is a steep hill in the form of an administration intent on dismantling the system. As I see it, if there wasn't this perpetual war on capitalism, all the numbers would be way more robust.

The equity markets, despite recent softness, continue to display great resiliency, with all bouts of selling for the last 18 months or so stopping short of a correction (10% decline). Housing has shown steady improvement, auto sales are back at all-time highs, and the labour market shows marginal, but steady, improvement. There appears to be a growing split faction within the Federal Reserve on exactly if or when to tighten policy while, in the meantime, politicians continue to do bupkis except create hollow arguments about nothing.

Europe continues to struggle, but just embarked on their first form of quantitative easing (QE) a couple of weeks ago – deflationary pressures seem to be the fight there. Japan's economy continues to show improvement while the jury is still out on China, which has stabilized it seems for the short term, but longer-term challenges remain.

The biggest questions (and concerns) right now which could derail things are:

- Does the Federal Reserve tighten sooner than expected?
- Can the European Central Bank (ECB) do as much as it believes when it says it will do "everything possible"?
- Do geopolitical (Russia/Ukraine, ISIS, Gaza) events escalate?

The market's strength has been impressive, but while the "melt-up" scenarios feel good as they happen, they typically end ugly and abruptly. This (and all the other 5-6%

Ignore the Naysayers

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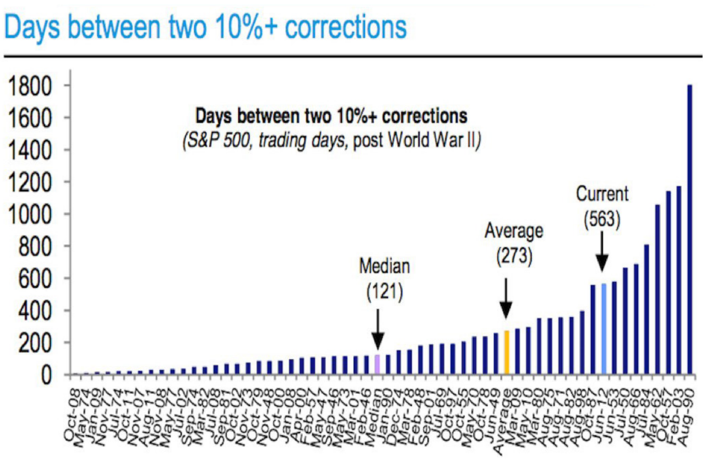
pullbacks) is welcome and keeps shaking the trees to keep investors honest. Personally, I would prefer a "grind-up" type of market rather than a "melt-up" type. Remember the old Wall Street adage that bull markets climb walls of worry.

The main reason for my continued optimism is the simple fact that global economies are improving. In the end, I've learned all markets care about is: Are things getting better? Or are things getting worse? And although equities have had a good run, earnings continue to grow and valuations are still reasonable and nowhere near prior cycle highs.

So while the rally may be long in the tooth, is that the reason it should end? I know the fact it's been a long time since we've had a 10% correction (hard not to, we are reminded daily on CNBC, BNN and other media outlets). But don't fret a market correction or be obsessed with a pending crash which may or may not come.

In fact, absorb this factoid: If the current rally was made to match the longest period on record without a 10% correction, it would have to occur on October 19…2017.



Source: Bloomberg Finance LP, Deutsche Bank Research

What usually kills market cycles (and rallies) on a macro level are the same usual suspects: Inflation, too strong economic growth, recession and/or the Federal Reserve.

And where are they right now:

Inflation: No
Strong Economic Growth: No
Recession: No
Federal Reserve: On hold

We can add to that list with current risks to the market/economy, as evidenced in the table below.

Risk	Short Term	Long Term	Impact (My Guess!)
Geopolitical			
• ISIS	Yes	No	10%
• Russia	Yes	Yes	20%+
Federal Reserve	Yes	No	20%
China's Economy	Yes	No	15%
Europe's Economy	Yes	No	10%
U.S. Economy	Yes	Yes	20%
Market Overvalued	No	Yes	20%+

The new Fed Chair, Janet Yellen, has worked hard to convince the street that the Fed is still its friend, even as the current reduction of tapering gets them closer to the real moment of truth – rate hikes. The Fed has made it clear that as long as inflation remains subdued, it's not going to panic. Right now it looks like a spring/early summer rate increase is in the cards, but it's still hard to fathom that the U.S. economy is booming, especially when everyone seems to think that a 7.0% growth rate for China passes as a Great Depression in that country. The markets will most likely have a knee-jerk reaction lower when the Fed raises rates, but historically they rebound nicely and it's usually not until the third rate increase where markets really get worried.

There is no doubt there is lots of disagreement within the Federal Reserve regarding the timing of the first rate hike. The Fed has a difficult needle to thread but disruptions and volatility will accompany any rate increases, no doubt about it.

U.S. midterm elections have typically created some volatility as well, and this year will be no exception. While the president appears to be on auto pilot, there's lots that should be addressed like tax reform, regulation, health care, immigration, etc., but expect little to get accomplished on those fronts.

How Much More Time Does this Bull Have to Run?

In terms of time, the honest answer would be "I have no idea." If pressed for a guess, to use a baseball analogy, I would say we are in the 5th-6th inning. But instead of thinking in terms of time, investors should prefer to think of the events listed earlier which could change the cycle.

One way the bull could end is the onset of recession. At some point in the economic cycles, recession is inevitable. But they don't come out of the blue and right now, most of the typical causes are not there.

Tax hikes could cause a recession, but as stated earlier, I think Obama is coasting so don't expect much until at least 2017.

Ignore the Naysayers
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Trade protectionism has caused recessions as well, but since Congress can't even pass the salt right now, don't see this as a possibility. Oil prices have collapsed from $110 to $90, so that is stimulative, not hurting.

Another financial panic? Maybe, with the epicenter out of Europe or China, but rarely do these events happen so close given 2008-09 was just five years ago. Given better bank balance sheets and capital ratios, another panic doesn't seem in the cards.

Finally, a huge expansion in government could stop the run. And while the size of government under President Obama has exploded, it now is declining as a share of GDP the last couple years. The political winds are shifting globally and the President seems to be a lame duck already.

So in my opinion, while the bull market is no spring chicken, from both a valuation standpoint and given events which might happen, the biggest risk is the Fed policy doing too much, too quickly. Europe has headwinds and plenty to be concerned about, sure, it's still a mess – but the situation is slowly getting better. China concerns have a huge impact on Canada given the implication on commodities, but the slowdown should be contained. The biggest risk there is a sharper downturn in their property market which many suggest is 25% of their GDP and the ensuing risk of loan defaults.

So the bottom line is that correction or not, markets seem likely to continue their upward momentum. Although volatility will rise with the Fed/interest rate uncertainty combined with the pending U.S. midterm elections and current geopolitical events. An improving economy, decent valuations, and a still accommodative Fed lead us to believe dips are buying opportunities.

Stay tuned,

Vito

Quotes

"Always do right. This will gratify some people and astonish the rest."

– American Author, Mark Twain

"A man who wants to lead the orchestra must turn his back on the crowd."

– Christian Author, Max Lucado

"Never mistake activity for achievement."

– Legendary Basketball Coach John Wooden

"The opinion of ten thousand men is of no value if none of them knows anything about the subject."

– Marcus Aurelius, Roman Emperor

"Nobody goes there anymore, it's too crowded."

– Yankee Great and Catcher, Yogi Berra

(On why he doesn't go to Ruggeris, a St. Louis restaurant)

Notes

Largest Crude Oil Producers (In millions of barrels rounded)

1. Saudi Arabia 11.0
2. Russia 10.0
3. USA 10.0
4. China 4.1
5. Iran 4.0
6. Canada 3.9
7. UAE 3.1
8. Mexico 3.0
9. Brazil 2.5
10. Kuwait 2.4

(Source: The Gartman, Feb 5, 2013)

GDP Production 1998 vs. 2012

	1998	2012
Canada	0.6	1.7
China	1.0	7.3
USA	8.7	15.0

(Source: Advisors Edge Magazine, June 2013)

Q: The state with the highest percentage of people who walk to work?

A: Alaska

Q: The percentage of Africa that is considered wilderness?

A: 28%

Q: The percentage of North America that is wilderness?

A: 38%

Around the GLOBE

Canada (Buy)

- Canadian dollar has plunged in recent weeks
- Canadian economic recovery has been confusing to say the least
- Q2 GDP was +3% annualized
- Major obsession in the media seems to be the state of Canadian real estate market
- Commodities, materials and energy sectors beat up of late over features of China slowing

U.S. (Strong Buy)

- U.S. economy appears to be finally gaining some momentum; last GDP print was 4.6% for Q2
- Central bank on verge of tightening?
- U.S. dollar has been very strong
- U.S. midterm election in six weeks could have a huge mental impact

Europe (Strong Buy)

- Two weeks ago embarked on their version of Quantitative Easing
- Ukraine conflict has been a big negative, as has proximity to Middle East events
- Euro has plunged, which is a consequence of QE, and big exporters there like Germany don't mind a lower euro

Asia (Hold)

- Japan's central bank still delivering stimulus
- Chinese housing is slowing, no stimulus seems to be coming for now
- China converting from a producing to consuming-led economy will have some speed bumps

Emerging Markets (Buy)

- Over past few years, their growth has decelerated but now seems to be reversing
- EM's continue to trade at long term lows in terms of valuations

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 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 numbers 519-675-2011 or 1-800-265-5911. Thanks for keeping us in mind.

Congrats, P.E., our winner this quarter!