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

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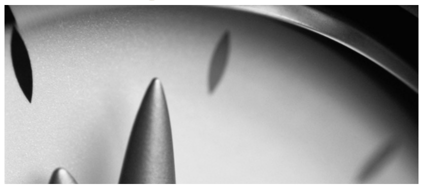
The big Picture



"The pessimist sees difficulty in every opportunity. The optimist sees opportunity in every difficulty." Winston Churchill

CONVENTIONAL WISDOM, THE GREAT REFLATION AND THE NEXT ROOM

Conventional wisdom is usually wrong.

If we look back at very recent history, most of you will remember:

In the early 1970's, nuclear war was inevitable. China was not a player.

In the 1980's Japan was going to rule the world (remember they bought Rockefeller Centre and Pebble Beach?), the US and USSR were the superpowers and would rule forever, and China, still was not a player.

In the 1990's, free trade would make Mexico a force to be dealt with, the fall of the Berlin Wall would bring prosperity to Europe, and China, as the last bastion of Communism, would never be a player.

But now as 2010 ends and 2011 begins, what is the conventional wisdom? That Iran will be a nuclear power and a threat, Iraq and Afghanistan will go on forever, China will rule the world and that the USA is in decline and is no longer a superpower, to be besieged by the growing debt and pending super-inflation.

Sure, there is a global transition occurring. The demographics have swung to a large number of mature workers (the Baby Boomers), to a smaller number of young workers (Generation X and Generation Y). As a result, global economies face lower consumption, lower capital generation and deflationary pricing pressures downward as a result.

The world consumer market is an estimated $20 trillion, of which $11 trillion is the USA (or about 55%) despite only accounting for 5% of the world's population. From 1982 to 2007, thanks to Reagan, Thatcher and so on, we enjoyed the benefits of lower taxes, less regulation, less government and more leveraging due to lower interest rates. Conventional wisdom, again, says that is all about to change.

Today we're seeing a mood of widespread fear and intense pessimism, and a distrust of government, as many investors feel overwhelmed by problems in Europe, the US (led by high unemployment), government deficits, depressed housing, and inept powers that be.

It appears there is a global, quietly desperate push taking place to create alternate currency structures to the US dollar and Euro. The problem with this, of course, is size. Thus moving out of these currencies leaves few options that can handle the large scale flows. In the meantime, proxies like the Yen, Gold and Commodities are being used as large pools of money seek anything with liquidity with no exposure to Western Currencies. That seems to be the consensus.

Look at gold. The price indicates higher demand but that may not be the story. The story may be the source of the demand. The push was from investment demand, not industrial demand i.e. Gold-related ETF's. Gold demand rose 414% in Q2 alone. India, the world's largest purchaser of bullion, now has seven Gold-backed ETF's. As of June 30th, those ETF's held $400 million of gold, up 100% in one year.

I've never been a gold bug, but I believe the commodity sector is in a longer term bull market; which historically, tend to run in 18 year cycles. If this cycle began in 2000, peak prices will occur in most commodities somewhere between 2012 and 2018. You've already seen big moves in energy, gold and silver, now agricultural commodities seem to be kicking in (note Potash takeover). Shortages in food stuffs are breaking out globally (food riots in parts of Africa, Russian grain exports, etc…). Hard assets could have a ways to go, particularly relative to paper assets, as capital markets seem to be concluding that central banks will have to print even greater amounts of money in order to relate their economies or to eventually pay off debts in America and Europe.

Monetary inflation is being built into the system which should buy hard assets and inflation expectations over the long term. So far however, reflation efforts seem to have had limited effect, as deflation forces from Japan and China's exports remain strong. This could prove to be an interesting time, as pockets of inflation are likely to develop in emerging economies, resulting in capital controls and interest rate hikes, while deflation appears due to excess capacity and excess labour in developed economies. For North America, inflation seems to be the least painful way out of this right now. For the rest of the world which holds US debt, that may not be such an attractive option.

Political pressures are mounting to push countries toward non-market solutions, and when a few move in that direction, it puts domino-like pressure on others to follow. Most developed countries face the same issues as the USA: high structural unemployment, weak growth, frightening debt projections, and impotent monetary policy. Everyone thinks they will export their way to growth, but not all countries can be on the same side of that ledger. So expect individual nationalism, currency manipulation, and protectionism (sounds like the 1930's?) to increase as country's cry "every man for themselves." Reality may be more spending and bigger deficits, as weak politicians refuse to make the "tough" choices.

This new age of deleveraging was sired by the back-to-back collapses of the housing and financial bubbles of 2007 and 2008. The good life of rapid growth that started in the early 1980's fueled by financial leveraging and historic low interest rates, created two bubbles in the past decade, the dot-com bubble and then the housing bubble. The consensus (again!) seems to be that the deleveraging could take up to a decade to complete, and that's the good news. If done any quicker, it would trigger a worse recession or even worse, depression. The reality is deleveraging never occurs in a straight line, but is often highlighted by seemingly isolated events. Many believe that US GDP will average 2% annually in the years ahead – far below the 3.3% growth required just to keep the unemployment rate stable.

So consensus seems to be that the USA is doomed, there's no way out from their problems and deficits, future entitlement promises, and a dysfunctional political system. In my few pessimist moments, I worry the consensus is right.

I get the problems. I'm not ignoring them. But when I hear and read that we are in "unprecedented" times, we've never seen this before, etc… I remind myself how selective human memory can be. In the early 1980's, the USA was done, in disarray, un-respected after the Carter Presidency, and fiscally a mess. Folks, New York City, the largest city in the land, went broke. Remember that? So there is always a way out, but it requires a lot of hard decisions, and more importantly, the political will to do so.

How about a country which had a worse problem than the USA? They were on the ropes, issued bonds no one wanted, the currency looked like it was worthless. It took a somewhat left wing government to make some hard choices and turned things around in two, yep two, years. That country my friends was Canada in the early/mid 1990's.

"Debt and deficits are not inventions of ideology. They are facts of arithmetic" Paul Martin, Canada's Finance Minister

If you roll the clock back to 1995, Canada was actually deeper in debt than Italy. How many of you recall the "Loonie" referred to as the Northern Peso? The Wall Street Journal ran an article in which the authors said the situation for Canada was so dire that we'd become "an honorary member of the Third World in the unmanageability of its debt problem." A full one third of all government revenues went to interest costs (to compare, it's 10% in the USA today).

So I do NOT accept the fact that America, the greatest economy ever built by capitalism is going to passively accept the "disastrous path" consensus seems to believe they are on. The public backlash in the mid term elections against insane fiscal policies was unmistakable, and it was across party lines.

How did Canada get out of its jam and get to where we are today, the most fiscally responsible of the G20? We reduced government spending, cut government jobs (14%), reduced grants to the provinces, modified welfare, cut corporate taxes (9%), reduced capital gains taxes and income taxes, instituted the GST, etc… The Federal budget was balanced within 3 years followed by 11 straight budget surpluses, reducing our debt from 80% of GDP to 45%.

So now what?

The #1 axiom in investing has been don't fight the Fed. And right now, the US Federal Reserve is stacking the deck in favour of buying stocks, not bonds. Add to that the fact most markets are still 20% or so below 2007 highs, as we enter the economic "sweet spot" of the Presidential cycle. For stock markets, the "sweet spot" is the third year of a Presidential term. The pattern is not perfect, but even 2007 had a slight positive. In fact, in the years from 1946 to 2009, 62% of all US economic growth came in the last two years of the presidential terms, compared with 38% in the first two years. The last time markets were down (and slightly at that) was 1939. And the average return in year three? It is 17.5%.

And given the boom in bonds yielding virtually zero, Bernanke's promise with QE2 (and maybe QE3, QE4…) to keep real interest rates on the floor until the level of economic activity picks up, Mr. Bernanke is in effect forcing other major central banks to join in an historic experiment in monetary policy. I think eventually some of that record amount of cash on the sidelines will tire of earning zero and the animal spirits of capitalism reenergize, where the fitter parts of the global economy gradually pull the weaker parts out of their slump with inflation in emerging markets and commodities, or high growth with low real rates. This, economically speaking, has been a rare event, but would be potentially very bullish for markets.

The consensus is composed of three myths:

1. The US consumer is overleveraged and done

2. That government debt levels are insupportable and

3. That potential growth in the West is set for a structural decline.

I do not believe any of them.

The US economy may be growing only 2-3% GDP, but it is growing and in recovery. And historically once underway, recoveries tend to go a long time. The last four cycles were seven, ten, nine, and eight years long. We are now perhaps 1.5 years into recovery. We are just started. But investors like to chase the last good story, and right now the last good story was bonds as rates went to zero, they had positive returns for 10 years where equities were flat to down.

So despite the fact we have experienced one of the greatest market bounces in history of financial markets, many investors remain anxious and worried. History shows the more severe the downturn, the more powerful and enduring the subsequent bounce. This has been true for 100 years.

Interest rates are low, and will remain there for some time. Corporation balance sheets are in the best shape they've been in decades. Consumer savings rates in North America have gone from 0% to 6% in two years. Sentiment remains pessimistic; it will take some time to get euphoria back which occurs at tops. Investors remain wary and keep finding things to worry about. When we get euphoria, I will worry more.

I will leave you with one more quote:

"The US economy remains almost comatose…The current slump already ranks as the longest period of sustained weakness since the Great Depression…Once-in-a-lifetime dislocations…will take years to work out. Among them: the job drought, the debt hangover, the defence-industry contraction, the (banking) collapse, the real estate depression, the health-care cost explosion and the runaway federal deficit." – Time Magazine, September 1992

History may not repeat itself, but it is said it sure does rhyme. The issue came out just as the biggest bull market of the last century was picking up steam (1992 to 2000).

Sure there will be set backs, but I would guess we will see new all time highs sometime in 2012, and one year from now there will be the usual chants of "should of" and "could of".

I remain an unabashed optimist and capitalist.

I wish you first, all the best for health and happiness in 2011, those are the primary objectives we should all strive for; secondly all the best for financial prosperity.

The Little Picture

We have made some changes to our systems and processes and are once again taking on new clients in 2011. Please don't keep us a secret. If you have friends, family or colleagues who would like a second opinion or who need a plan, please do not hesitate to pass our name along. We only have one qualification they have to be nice people! Our growth comes 100% on introductions from satisfied clients.

We'd like to meet more people just like you!

PORTFOLIO CORNER (prices at open Jan 5, 2011)

Our picks in 2009 have turned out quite well, led by names like ARC Energy Trust, BCE Inc., Telus Corp., General Electric Corp., Caterpillar Inc., Dow Chemical Co., Deere & Co. and Diageo PLC, among others.

Names we recommended in 2010 like BCE Inc.(again), Pengrowth Energy Corp. (formerly Pengrowth Energy Trust), Crescent Point Energy Corp., DuPont, McDonald's Corp., Verizon Communications Inc., Research in Motion Ltd., Teck Resources Ltd., Toromont Industries Ltd., and yes even BP PLC…were ALL huge homeruns. The casinos were huge for us.

So what does my crystal ball say for 2011? In Canada, I think commodities will do well, but with lots of volatility. Focus on energy (Suncor Energy Inc. - **SU**, Canadian Natural Resources - **CNQ**, Nexen Incorporated - **NXY**); converting trusts (Pengrowth Energy Corp. – **PGF,** Bonavista Energy Corp. – **BNP**, Canadian Oil Sands Limited – **COS**). The recent pullback in Royal Bank (**RY** - $52.10) and Bank of Montreal (**BMO** - $57.79), have also created opportunities. Call me crazy, but natural gas intrigues me, the BMO Junior Gas Index ETF (**ZJN** - $20.12) is a great way to play the juniors and for aggressive types the Horizon's BetaPro 2X Natural Gas ETF (**HNU** - $7.12) to play commodity. Still like Research in Motion Ltd. (**RIM** - $58.85) at these levels: for aggressive names Canada Lithium Corp. (**CLQ** - $1.78), Sandvine Corp. (**SVC** - $2.85) and Zarlink Semi-conductor Inc. (**ZL** - $1.81). Manulife Financial Corp. (**MFC** - $17.25) and Sun Life Financial Inc. (**SLF** - $30.22) also interest me.

In the USA technology, financials, industrials. Bank of America Corp. (**BAC** - $14.19), Citigroup Inc. (C - $4.88), Visa Inc. (V - $70.84) in the financials: Qualcomm Inc. (**QCOM** - $51.55), MGM Resorts International (**MGM** - $15.24). In natural gas names: Petrohawk Energy Corp. (**HK** - $18.70), Southwestern Energy Co. (**SWN** - $37.35), Chesapeake Energy Corp. (**CHK** - $26.14) and the drillers Valero Energy Corp. (**VLO** - $23.13), Tesoro Corp. (**TSO** - $18.44). The shippers as a group are still down huge from 2007: Dryships Inc. (DRYS - $5.31), Diana Shipping Inc. (**DSX** - $12.22), Genco Shipping and Trading Inc. (**GNK** - $14.77), Overseas Shipholding Group (**OSG** - $35.84), Nordic American Tanker Shipping (NAT - $26.05) or the Guggenheim Shipping ETF (**SEA** - $28.66). For aggressive names, ProShares ETF/short bonds (**TBT** - $38.27), Office Depot Inc. (**ODP** - $5.77), Sprint Nextel Corp. (**S** - $4.46), Sirius XM Radio Inc. (**SIRI** - $1.67), Banco Santander (**SAN** - $8.00)

Around the globe

Canada (Strong Buy)
- Economic growth cooled substantially in second half
- C$ outlook tied to global outlook, especially China and its demand for commodities
- Short rates should remain historically low for some time/ housing cooling?
- Best fiscal situation in G8

U.S.A. (Strong Buy+)
- Recent economic releases have dampened fears of a "double dip"
- US unemployment picture remains depressed
- US appears committed to devaluing the US dollar
- US Fed a long way from raising rates

Europe (Trading Buy)
- Crisis is on again, but contagion has not spread beyond Europe
- German economy powers ahead on exports due to low Euro
- UK outlook improving, mixed growth but high inflation
- Ireland and Greece have already negotiated bailout packages, whose next?

Asia (Buy)
- India remains strong, China policy aims to slow economy but growth remains strong
- Japan's stimulus cooled Yen, raised equities
- Chinese government most worried about implications of a rising currency

Latin America (Avoid)
- Brazil expected to grow 7.8% in 2011, strongest in 25 years
- Rest of region still fighting left wing politics and corruption

NOTES

The Sweet Spot?
The third year of a US President's term has not been negative since 1939 (when it was just flat), and the average return has been 17.5% in year three. Three months after mid terms, US shares have been negative just twice since 1926 (1938 and 2002). Overall, up 7.6%. Six months after mid terms, the last time it was negative was 1938, with a six month average of +13.9%. Nearly 50% of the time, 6 month returns were › 20%. (Bonello Financial 12.22.10)

Not so Great Return So Far?
The Obama Administration has touted their stimulus program as having created 640k+ jobs since enacted February 2009. Based on the $157 Billion awarded as of October 2009, that worked out to $246,346 per job! Total average compensation per employee in the USA is approx. $60,000, so if the government had simply paid people for a year's average work, it would have paid for over 2.6 million jobs! Nothing beats a government program, eh?

The 5 Worst Business Tax Climates in the USA
1. New York
2. California
3. New Jersey
4. Connecticut
5. Ohio

(Typically all strong Democrat states and coincidentally, most are at the top of the list to default!)

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 with a nice dinner at one of the finer restaurants in London.

Congrats, Tom T.

Our winner this quarter!

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, we would be grateful if you passed on our number: (519) 675-2011 or 1 (800) 265-5911. Thanks for keeping us in mind.