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

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The big Picture

Annus horribilis

I knew my high school Latin, which I was forced to take, would eventually pay off. I just didn't realize it would be 30 years later and after a year like 2008 in the financial markets. Somehow, saying "horrible year" just doesn't resonate as well as it does in Latin. But horrible it was. There is no possible way to sugar coat anything that happened this past year. It was a year where the only thing that performed worse were the 0 – 16 Detroit Lions. And like the Lions, there were absolutely no winners to be found.

The best-performing major market in the world was Japan's Nikkei, down approximately 13%. The TSX in Canada down 33%, the S&P 500 23%; most European markets 30 to 50%, former "hot areas" China and India 55% and 53%. Financials globally were decimated and commodity stocks which were up huge as late as July, collapsed and gave up 50% to 75% in mere months. From summer highs, most markets were down 50%+.

The bulk of the damage occurred during the months of September and October, but November didn't help much. From September 1st to October 20th, there were 67 significant global financial events in just six weeks, and very few could be taken as positive events. But the true cause of the damage wasn't confirmed until mid December, when the $50 Billion Madoff scandal broke.

My comments and writings of the last quarter with respect to the forced liquidation of hedge funds (fraud and legitimate ones) and the amazing late day sell-offs and huge drops in matters of minutes only confirmed that these massively leveraged holdings were being sold to cover massive margin calls and client redemptions. Unfortunately everyone suffered as a result. So a "normal" bear market drop of 25 -30%, became a "mama bear" market of 50%+. But despite the horrible mess the world seems to be in, the comparisons to the Great Depression are overdone. The phrase "since 1931" has become too common in the media. While this is a tough recession, the comparisons are not even close.

Everything but the kitchen sink is being thrown at global financial markets. The initiatives that have been undertaken by the U.S. in a coordinated fashion with other governments and their respective central banks are unprecedented. Fed chair Bernanke's appointment and his

Key Factor	Great Depression	Today
GDP Growth	- 27%	-1 to -4%
Industrial Production	- 52%	- 2%
Unemployment Rate	25%	6%
US Exports	- 66%	+ 15%
Consumer Price Index	- 27%	+ 4%
Money Supply	- 29%	+3%

(Source: National Bureau of Economic Research)

expertise of the Depression seems to have made him the right man in the right place. He has been pro-active and innovative. Interest rates are virtually zero, money supply is off the charts, and bailouts (like them or hate them) are huge. The amount of effort and dollars being thrown at the situation only emphasizes the seriousness, at one point, in the words of Mr. Bernanke, "perhaps days away from a complete meltdown of the financial system, with implications in the USA and globally." The absolute loss of confidence in the entire financial system has widened credit spreads and all bank credit and lending had virtually shut down.

What essentially is unfolding is the bursting of the real estate bubble, which became the catalyst for the bursting of the credit bubble that had been building for the last 20 or so years. Logic would lead one to guess this will most likely lead to a prolonged period of credit deflation, debt liquidation, and little or no inflation or economic growth. The consumer's balance sheet has been hit on two sides, declining home equity and falling investment values, how long before they ratchet down their spending? The negative wealth effect will most likely lead to a slower recovery. While the recession may be longer and deeper than normal, the scare talk of depression is exactly that – scare talk. The world remains awash with excess savings and the developing world has a burgeoning middle class hungry for growth. At some point, with the meager returns available for T-bills and bonds, some of that money will move off the sidelines and trust and confidence will return.

SNAKEBIT PRESIDENCY - WRITING OFF AMERICA TOO SOON

Two numbers to make note of: 11,000 and 9,300.

What do those represent you ask? These were the approximate levels of the Dow Jones and TSX when George Bush was sworn in as President in January 2001. Eight years later and they closed 2008 at 8,776 and 8,988. That's right, the largest market (and economy) in the world returned a loss of over 20% over Bush's eight year term.

But without wasting another high school lesson (and my apologies to Shakespeare),"I come NOT to bury Bush, nor do I come to praise him."

"Dubya" became president in Jan. 2001, right at the top of the cycle and bubble. While many of today's events blew up under his watch, their seeds for disaster were planted in the mid to late 1990's, long before he was sworn in. And with the climax event of Sept. 11th, 2001, a mere eight months into his Presidency, it was to be one full of challenges with lots of room for errors. While I am not defending President Bush, what I will say that almost eight years later there has not been one single follow up terror incident on US soil, not one, and I don't believe their enemies have stopped trying, so logic would dictate they must have done something right to break up the terrorist network, their finances etc… and if the main purpose of any government is to protect its citizens, then they (Bush and his people) succeeded. But from the despair and frustration, and perhaps a tattered legacy (a recent *Rolling Stone* magazine cover called Bush "the worst President Ever"), history may yet judge him differently. The hope and optimism created by Mr. Obama's election could not have happened at a better time. The world has written off America, blamed all the globe's problems on them. Mr. Obama seems to be the antithesis of his predecessor, and comes in where things can only go up from here, not only in the markets but sentiment, consumer confidence etc…

The fact is there is almost a cheering for the demise of the United States, for their perceived arrogance and comeuppance. But the fact remains that the US remains the world's largest economic and military power, and it will take decades for any to supplant that. What those that criticize (and in my opinion, envy) the USA forget, is that America has set the tone for the rest of the world, creating the template for prosperity, and they have shared this template willingly. The USA has never been ordained to be the leader of the world, but it earned that distinction through valour, innovation and determination. By giving the world trillions of dollars since World War II, and giving thousands of lives to fight a series of oppressive philosophies from Nazism, Communism to current day terrorism, it has earned the right to be respected.

The mere notion of the election of the offspring of a mixed marriage middle class kid to the most powerful position in the world only confirms that anything is possible in America. Not many countries, maybe including our own, can boast that. I wish President Obama safety and all the wisdom he needs to govern the greatest nation on earth. Whether one believes it, or likes it or not, the world needs a strong and sound America.

QUOTES - ALL FROM PERHAPS THE GREATEST ECONOMIST EVER, MILTON FRIEDMAN (1912 - 2006)

"A society that places equality over freedom will end up neither. A society which places freedom over equality will end up with a great deal of both."

"If a tax cut increases government revenues, you haven't cut taxes sufficiently enough."

"Nothing is so permanent as a temporary government program."

"Inflation is taxation without legislation."

"The economy and the stock market are two different things."

Pray for Deficits

The amount of money being thrown at the current crisis will create huge deficits. The bears say this will end up in Armageddon. The facts say otherwise. Historically U.S. Federal deficits are associated (at least in the short term) with bull markets. Deficits increase the velocity of money and some of that money ripples into financial markets sending prices up. The historical pattern is unmistakable: when the Federal deficit spikes, stock do well in the intermediate term.

The biggest spikes in the deficit relative to GDP were Q4 1949 (3%), 1958, 1971 and 1975 (2%, 2%, 6%), 1982 and 1992 (5% each). In not one of those six cases were the subsequent 12 and 24 month returns negative, the averages were 21% and (annualized) 12% respectively. Surpluses have been followed, on average, by subpar returns.

Next year's Federal deficit is expected to be 4.9% of GDP. In other words we have one of those spikes.

From high school to University now:

My Keynesian economic classes at Western taught me that the motivation for a deficit was to increase the speed at which money changed hands to avert stagflation. If consumers and businesses wouldn't borrow money and spend it, the government steps in to prime the pump. While there can be negative repercussions from overspending, deficits do keep things flowing.

Fear is already priced in and was at one of the highest levels I have witnessed in 25 years in mid October. It's priced into stocks and has had a depressant effect. The aftermath of this recession must be bullish. If investors want to remain preoccupied with the deplorable state of the world economy, I guarantee you they will miss most of the recovery in the market.

Notes

According to Fitch Ratings, two thirds of the housing loans that had defaulted in the past 12 months were from borrowers who bought but never had any intention of living in the homes. In other words: speculators in real estate. Those unoccupied homes became non-performing loans very, very swiftly. In Las Vegas last year, 60% of the homes foreclosed were unoccupied.

Why the world needs a strong USA?

Percentage share of Global GDP:

US Consumers	19.3%
Japan	9.1%
Germany	6.0%
China	5.5%
Britain	4.9%

(Canada is 2.6% by the way)

The top 10 equal approx. 64% leaving hundreds of nations to fill the balance. *(Gartman Letter Oct 30, 2007)*

And the USA is only 4% of the global population but… 85 million barrels of oil are consumed globally each day, with 25% (21 million barrels) feeding the USA. Not much new in those figures. But T. Boone Pickens estimates there are 115 billion in reserves available to the USA to drill but refuse to due to a lack of energy policy. *(CNBC July 8, 2008)* (Check out www.pickensplan.com for more)

And "my people" are doing what?

While most governments and central banks around the world extend bail out packages to financial institutions, automakers, energy etc., Italy has revealed a different priority. They have unveiled plans to buy 100,000 of the country's cheeses from producers at a total of about US $70 million. Cost of animal feed and milk has increased production costs and manufacturers are losing money on each Parmigianino they turn out. The cheese is being distributed to needy families. *(National Post 12-16-08)*

Portfolio Corner Summary

(As of close January 7, 2009)

This quarter's recommendations:

Needless to say, the names from 2008's January and April's recommendations did very well until August or so. Anything after that was beat up with the rest of the world.

For 2009, I think "themes" will dominate the investment horizon. While financials are tempting, there may still be some short-term issues to resolve, but if one must own them, stick with the best of class **RBC (RY $36.75)** and **TD (TD $45.20)** in Canada, **Wells Fargo (WFC $25.36), JP Morgan (JPM $27.90) and Bank America (BAC $13.82)** in the USA.

Healthcare fared well in 2008 (relatively flat) and I still like **Pfizer (PFE $17.40), Bristol Myers (BMY $22.13)** in the US, plus they pay nice dividends.

Energy may go lower but at some point will be a buy. **Suncor (SU $26.66), Husky Energy (HSE $32.05), ARC Energy (AET.UN $19.37), Canadian Oil Sands (COS.UN $21.92), Nexen (NXY $20.85)** are my favourites.

Infrastructure spending everywhere is going up. **Deere (DE $43.40), Caterpillar (CAT $42.93)** in the U.S., **Aecon (ARE $10.44)** in Canada. In steel **Russel (RUS $19.80)** on TSX, **U.S. Steel (X $36.98)** in the USA.

With markets down 40-60% globally, there are too many names to list them all. Industrials like **General Electric (GE $16.05)** and **Dow Chemical (DOW $15.83)** are cheap and pay nice yields while you wait.

Around the globe

Canada (BUY)

- Fears of recession have become reality and the magnitude of slowdown may be deeper and more prolonged as credit crisis has bled into the real economy
- We're about to "catch a cold" from our largest trading partner's "sneeze"
- Collapse in commodity area will hurt; combined with problem with automakers which will hurt Ontario hard in particular (per capita auto production here 2X that of USA)
- TSX down 45% just since July (and 38% since Dec 2007)
- Expect another .50% - .75% drop in rates

U.S.A. (STRONG BUY)

- U.S. GDP expected to decline by 1% in Q1 2009, and Q4 2008 was worst
- Inflation fears have gone to deflation fears in just one quarter since 1982
- U.S. dollar rebounded against all major currencies in Q3/Q4 2008
- S&P 500 down 40% since Dec 2007
- 10-year bonds currently yielding only 2.55%, unbelievable
- Consumer led recession after a 17-year spending spree came to an end
- Estimated $11 trillion has been wiped off household net worth between home prices and lower markets

Europe (HOLD)

- Germany's GDP declining quickly as biggest economy slows and ECB's late start to easing rates have hurt
- Severe housing slumps in UK, rates at 30% (lowest in 54 years)
- World Index down 45% last 12 months
- Interest rates will fall further

Asia (BUY)

- China's stellar growth has eased from 10-12% annually to 7.8% and many fear could go to 4.5% eventually – needs 8% to keep producing jobs due to shift from rural to urban
- Emerging market economies slowing as well as demand for their products has collapsed
- Japan's benchmark interest rate at 0.3%

Latin America (AVOID)

- We've been uncomfortable with the region for some time, mainly due to the left-leaning politics. Now with the collapse in oil prices, we will see if the if the emperor's have clothes. Nationalizations in Bolivia, Argentina, and Venezuela do not bode well to keep attracting foreign capital.

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.

Congrats, Audrey P.

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.