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Third Quarter 2010

September has been on average the stock markets' worst month. But this year, thankfully, after months of being marooned between a miserable economy and ultra-low interest rates, stocks set sail on prospects of QE2 (a second quantitative easing).

September was the best September in 71 years for the S&P 500 (up 8.9% in U.S. dollars, 5.1% in Canadian). For the 3rd quarter the S&P 500 gained a not too shabby 11.3% (7.6% in Canadian). The S&P is now getting close to its April highs. The Toronto stock index had a total return of 4.1% in September and 10.3% for the 3rd quarter.

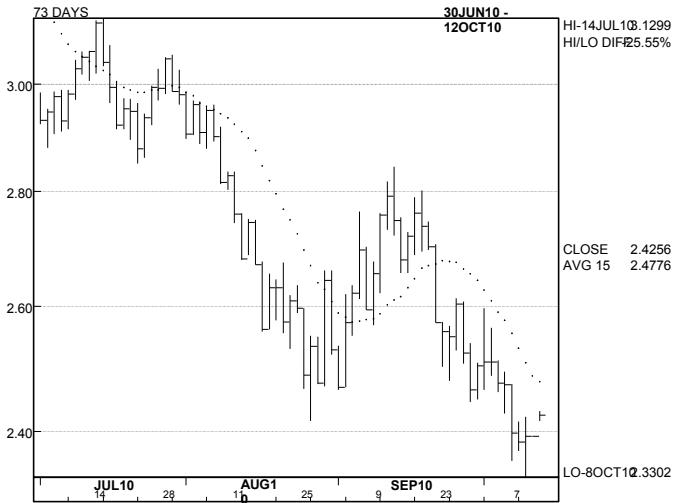
The RMS Queen Elizabeth I was decommissioned in 1968 and the RMS Queen Elizabeth II became the flagship ocean liner. Today QE2 refers to expectations that the U.S. Federal Reserve will announce in November a new program to buy assets (principally long and mid-term U.S. treasury bonds) to drive down interest rates (quantitative easing). After it took short-term interest rates to near zero in late 2008, the Fed spent \$1.7 trillion to buy bonds to float the economy in 2009. QE I was known as 'shock and awe'.

QE2 is apparently controversial even within the Fed, and is therefore no sure thing, although Chairman Bernanke (remember he's known as Helicopter Ben because as an academic he said that in the 1930s the Federal Reserve should have dropped cash from helicopters to get the economy going) has spoken in favor of QE2 recently. Quantitative easing is supposed to have this 'mechanism of transmission' to the economy: The Fed buys bonds to raise their price, which lowers their yield, which enables corporations to borrow cheaper, makes mortgages easier to refinance, and stocks relatively more attractive. Rising stock and bond prices help to offset ebbing real estate prices, to make consumers feel more like spending.

Anticipation of QE2 has already had notable effects in the bond, currency and stock markets. The charts that follow show that the ten-year U.S. Treasury bond yields have declined from 2.9% on June 30 to an amazing 2.4% today (3.1% to 2.7% in Canada):

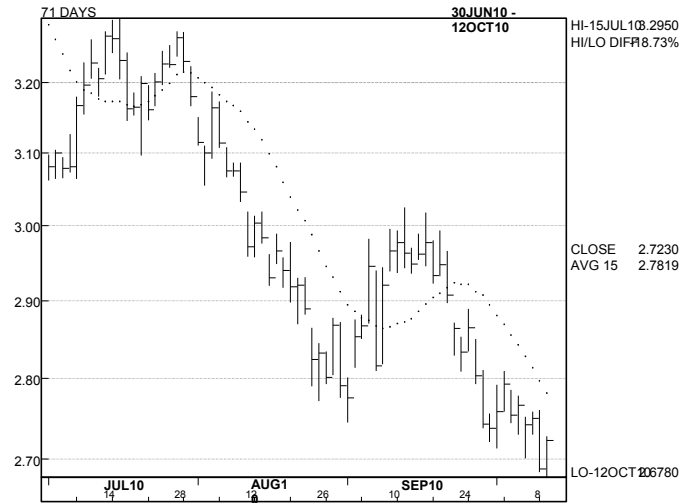
US TSY 10YR BOND YLD

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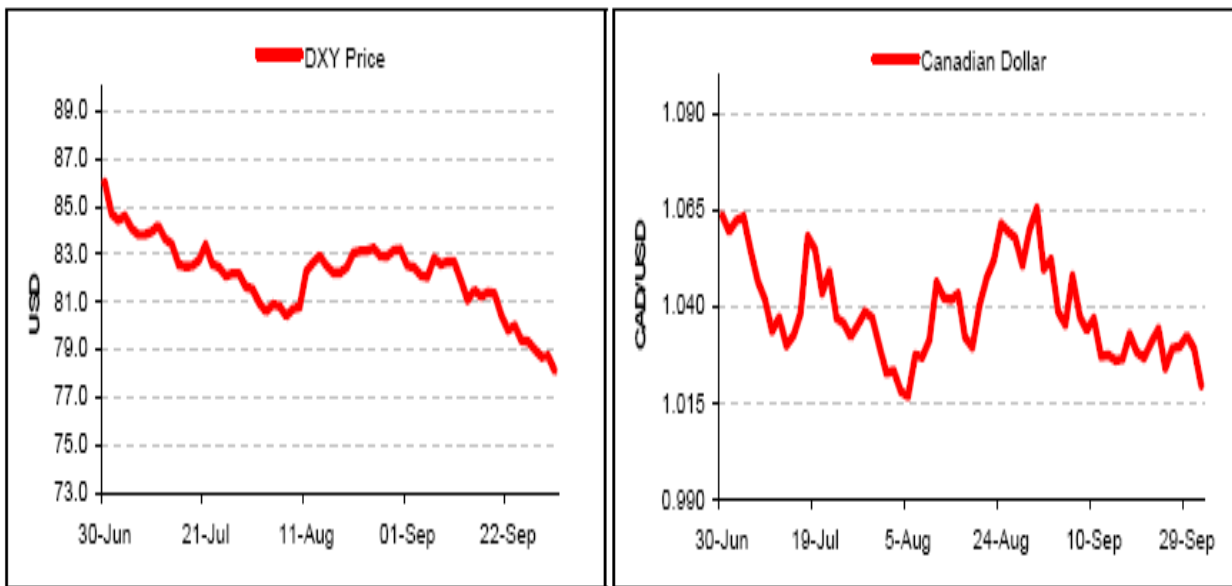


Source: RBC Trend & Cycle

Expectations are that the creation of so much currency (“what’s a trillion?” to paraphrase something that my Grandfather C.D. Howe didn’t actually say) is going to create an oversupply, as illustrated by the two charts below. In the 3rd quarter the U.S. dollar plunged 10% against a basket of currencies, and 3.3% against the Canadian dollar:

Trade weighted US dollar - 3 Months

CAD Currency - 3-Months



Source: RBC Capital Markets, Oct 12, 2010

Debasement of the U.S. currency is also reflected in the price of gold and by Dr. Copper (the commodity with a PhD. in economics):

GOLD 100 OZ FUTURES

GOLD.ZZ.U

COMEX COPPER - NEAREST MONTH

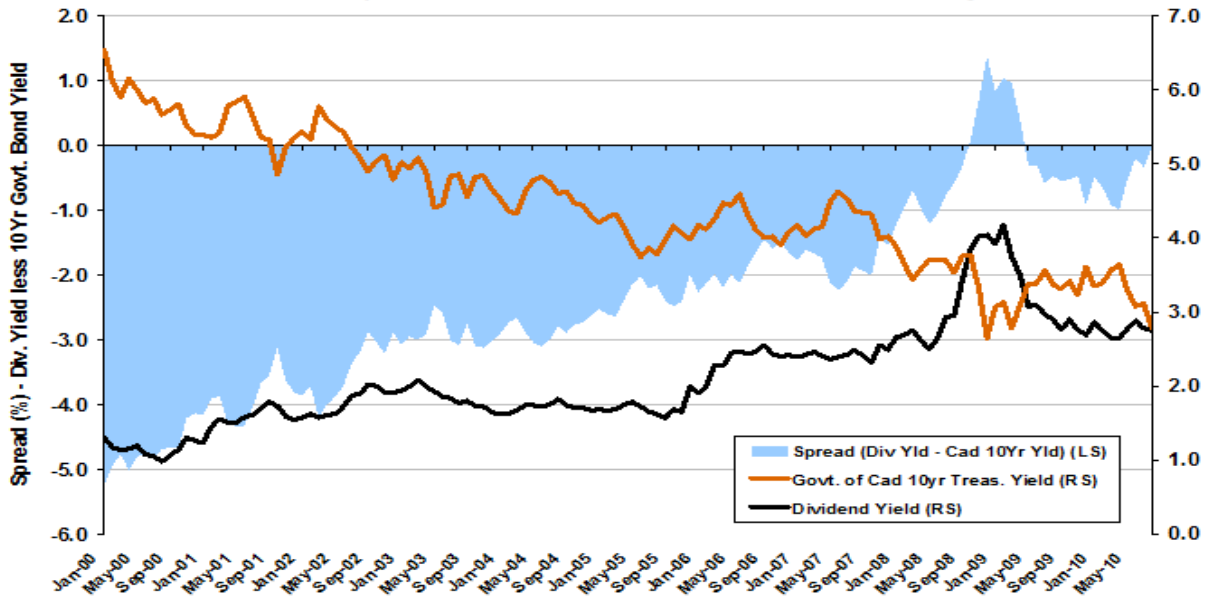
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Source: RBC Trend & Cycle

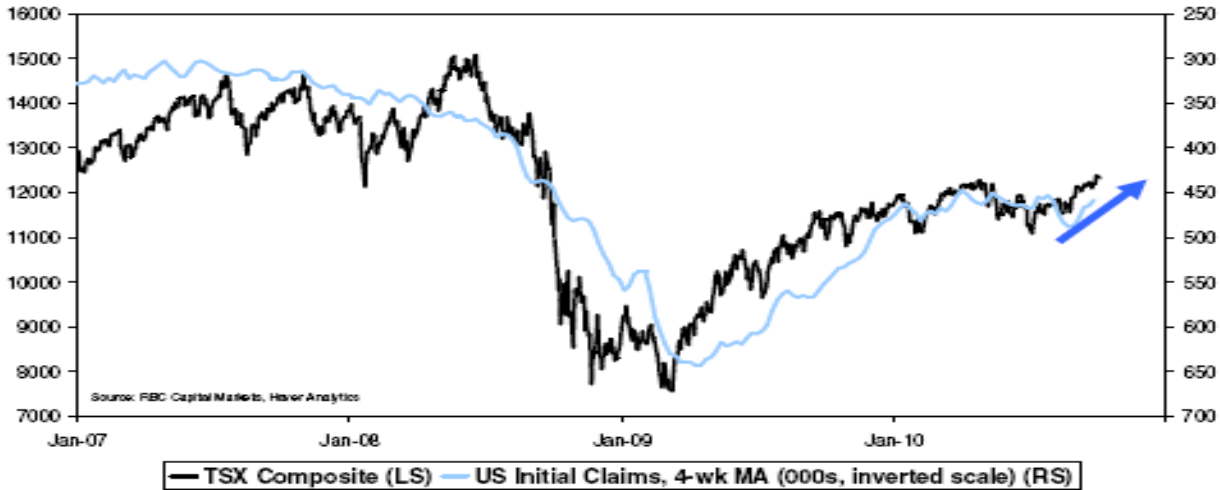
As mentioned, stocks generally had a fabulous September. Speculative stocks and commodity stocks were big winners from the loose monetary conditions. The effect of dramatically lower bond yields was also pronounced on high dividend paying stocks. Now the dividend yield of the S&P TSX Composite Index is basically the same as the yield on the 10-year Canada bond, 2.9%.

Yield Analysis
S&P/TSX Composite Index vs. 10 Year Govt. of Canada Treasury Yield



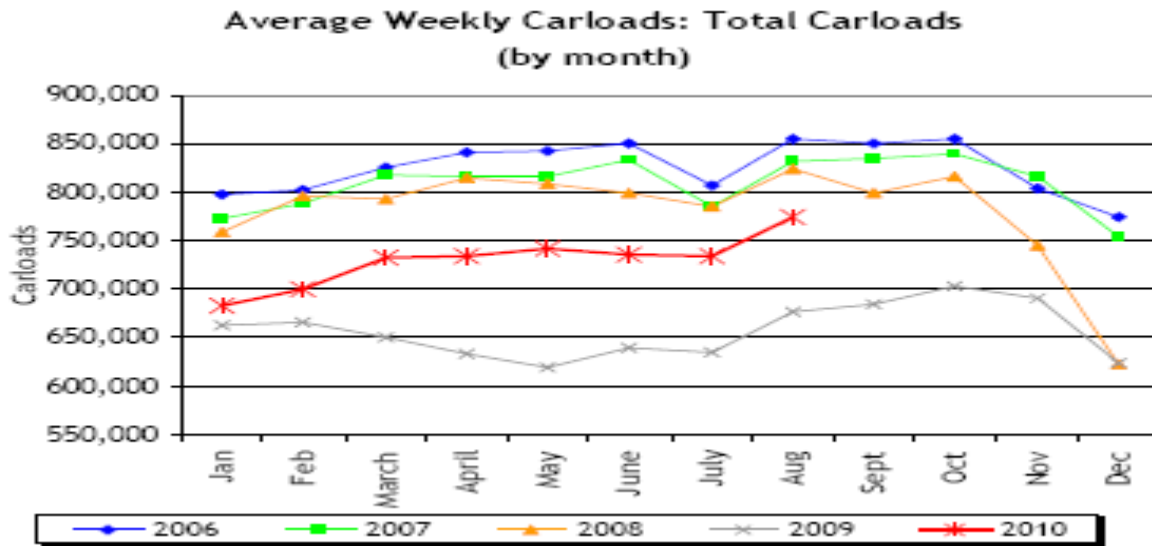
Source: Russell Investments

There is a little more than just the decline in interest rates behind September's improvement in stock prices. I sometimes wonder why anyone would try to relate the economy to stock prices as, at least in the short-term, the connection is so convoluted. But at least part of last month's gains must be attributed to some less bad economic data. For instance, the 4-week moving average of the U.S.'s initial unemployment claims has improved slightly this month. This chart relates unemployment to stocks:



Source; RBC Capital Markets, Oct 12, 2010

Warren Buffett has often said that if he had to choose one economic indicator he'd look at rail car loadings. That figure, he says, is a great real-time proxy for the health of the economy. Car loads have risen in 2010 and, while still below the peak levels of 2006 and 2007, they are well above the depressed levels of 2009:



Source; AAR. RBC Capital Markets

Speaking of Warren Buffet, he rarely makes forecasts, but on CNBC on October 5, referring to people's preference for bonds over stocks today, he was very forceful:

It's quite clear that stocks are cheaper than bonds. I can't imagine anybody having bonds in their portfolio when they can own equities, a diversified group of equities. But people do because they, the lack of confidence. But that's what makes for the attractive prices. If they had their confidence back, they wouldn't be selling at these prices. And believe me, it will come back over time.

To that I would only add that, as Bruce Berkowitz says, one thing the greatest investors have in common is that they never, never run out of cash. That way, in the event of the unexpected, they are not forced to liquidate at unfavorable prices and, as Dan Aykroyd says in his film with Eddie Murphy, Trading Places, they can "let fear be the other guy's problem".

I deliberately used the word thankfully at the beginning of this letter which was written on Thanksgiving weekend. While trying to explain the holiday to my 4 year old, I realized just how much I have to be thankful for. In my professional life I must thank you. My clients are the best. Also, I don't thank my fabulous Associates Andras Birkus, CIM and Agnes Beri, CIM nearly enough.

Sincerely,

George Stedman, CFA
Portfolio Manager

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