REVIEW & COMMENTARY
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Zero Tolerance

These are puzzling times. Six months ago equity markets were thought to be on the verge of a systemic meltdown. Since then, prices have rallied strongly suggesting that the worst case scenario, a 1930's type depression, has been avoided. Due to intervention by most Central Banks to avoid such a scenario, interest rates are low, to the point where cash and cash equivalents such as Treasury Bills and Bankers Acceptances are earning nothing or close to it. One reason why the equity markets have done well over the past two quarters is that cash investors are starting to seek higher return investments. As well, instead of financial Armageddon, a more accepted view is that global economies- though some faster than others- are on the mend. Thus, with the end of the financial world now only a fearful moment in the past, investors are becoming increasingly intolerant of a zero percent return. This would suggest that there is more upside for the equity markets given the enormous amount of cash on the sidelines and this doesn't include the potential upside when global economies improve.

Mr. Bernanke, the Chair of the U.S. Federal Reserve commented recently that the worst of the recent recession is "most likely over". Few would blame him for being cautious given the past year. We must remember that his comments will always be guarded and while it is important to not read too much into any one statement, he is extremely unlikely to be anything more than very conservative in his predictions. Thus, we will take him at his word that the worst is most likely over, suggesting that there are better times ahead. Add this to the liquidity argument and the worst of the equity markets is most likely over too.

While we are not suggesting it is time to celebrate the end of hard times, we and the markets are indicating that the prospects for the future are improving. Under normal circumstances, without the strong governmental intervention, interest rates would increase reflecting increased economic optimism. The U.S. Federal Reserve along with many other Central Banks has suggested that they collectively have little intention of easing their aggressive monetary policy until their respective economies are convincingly on stronger footing. Bernanke has been very vocal on this point and not until such time will he consider an "exit strategy" allowing for the present easy monetary policy to reverse. Thus, it may be some time before rates start to increase at least in the U.S. Further, we think he would provide more than enough warning of his intentions so that further modifications in a portfolio could be made.

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Bonds, namely corporate bonds, considered risky only six months ago, have reflected the new reality as nicely as equities have. While they provide a safer harbour than equities, they provide a fixed return if held to maturity. Market timing aside – which is equally difficult in the bond market as it is in the equity markets, dividends are preferable given they are not fixed, and in many cases they are raised at times when company executives consider their prospects improving. If this is any indication, of other companies, the CEO of Royal Bank of Canada recently suggested that raising the dividend was "on hold" very clearly implying that it was coming. And if this is any indication of the future then Canada, particularly the Canadian banking sector is in considerably better shape than their global counterparts. And a healthy banking system suggests a healthy economy- further signs that the worst is behind us.

Ample levels of cash are on the sidelines – all still searching for better returns. Corporations have lots of cash too. In Canada, total company financings year to date is $35.5 billion which has eclipsed all financings in 2007. In corporate America, non- financial companies have over $156 billion surplus cash relative to their capital spending requirements on their balance sheets, according to a recent Business Week column. This suggests that the recent increase in the take-over and merger activity may still have room to go. Money market funds in the U.S. now total in the several trillions of dollars- over one third of the entire value of the equity market- waiting for an opportunity. Thus with ample supply of cash earning meager returns, it may be much easier to take over a company, even at these levels, than try to build a business from scratch.

Market uncertainty aside, and we do not mean to downplay the difficulties that lie ahead for the US economy, cash tolerant investors look to a falling Consumer Price Index (CPI) and to bolster their argument. However, CPI it is not always an accurate reflection of what most investors face today. While the index has been falling, tuition costs and realty taxes have not. Nor have essentials like food and alcohol. Energy costs may be lower than they were 12 months ago, however, they are still considerably higher than they were two years ago when North American equity markets peaked and the prospects of a recession were a distant consideration. It may take some time for the economy to recover but it is important for Canadians and international investors to distinguish between the U.S. economy and the global economy. For the first time in over 60 years, the recovery may not be led by the U.S. It may be the emerging economies of India and China that may drag many of the industrial economies out of their lethargy and any resource based economy such as Canada may move faster than expected. If the pull from these emerging economies is strong enough, the U.S. economy may recover faster than many anticipate which again would be positive for equities.

Improving global fundamentals combined with high cash balances and ongoing Central Bank's stimulus programs suggest investors risk paying higher prices for risk assets if they remain on the sidelines too long. We believe that patience and tolerance is better served these days with a balanced portfolio rather than cash.

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