REVIEW AND COMMENTARY-2010

In our review last year, we ended our introductory paragraph with the following statement; "...The time to full recovery will vary but unless there is a systemic shock to the markets (i.e. geo-political conflict, US congressional intervention, etc.) world economies are on the road to recovery". Well, there were conflicts- North Korea flexing its military muscle which continues to play out, and while not typical of the geo-political turmoil, the ongoing financial battles among many smaller countries in the Euro zone to get their own financial affairs in order lends itself to an equally destructive outcome if those who have the financial strength don't provide the resources to those in need.

Last years predictions were…

North American equity markets will provide positive returns again this year. We had predicted that the returns, while not as great as 2009, would still be good in 2010. The SP500 was up 12.8 % in 2010 vs. 23% in 2009(US dollars) and the TSX SP gained 14.5% vs. almost 30% the previous year. Certainly this supports our prediction and reaffirmed our view that Buy and Hold is not dead (see our 3rd quarter 2010 commentary). Among the issues we thought might prevail in 2010 were increased mergers and acquisitions, a noted increase in debt financing, and an increase in dividends by many companies, most notably Canadian banks. While all but the latter was accurate, only National Bank increased its dividend in 2010. The hesitation by the other Canadian banks was more due to regulatory overview and constraint rather than financial uncertainty. We expect 2011 to see most, if not all, the Canadian banks follow National Bank's lead.

Many Global and Emerging Economies will continue to rebound and drag the US economy and many of the G8 countries along with it. While the US economic growth waned over 2010, there is little doubt that a significant driver was emerging economies. Central bankers in China continue to apply the financial brakes while the US accelerates monetary and fiscal policy and the global economy is being paced by China and India. Commodity prices and those countries who produce them (yes, that is Canada) have benefited economically more than the US, however, the demand pull side consequences demonstrate global economic improvement is evident. We also predicted correctly that the US dollar would not reverse its downward momentum and that the Loonie would move toward parity.

Bond prices in the mid to long term area will come under downward pressure particularly in the latter half of 2010. In particular we had anticipated that the US central bank would maintain a low interest rate policy but that "open markets will start to reflect higher interest rates thus pushing mid to long term bond prices lower before year end." Despite a second session of quantitative easing (aka QE2) interest rates, contrary to its primary intentions, moved up in the last quarter. Whether interest rates were merely too low (something discussed in one of our 2010 commentaries) and the market now is becoming more realistic, it nonetheless suggests that the yield curve is telling us something- the price of money is going up. This interest action suggests, at least partially, stronger anticipated economic growth (and a subsequent increased demand for money), inflation or a combination of both. Regardless, a moderate amount of both is good for equities.

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Predictions for 2011…

Volatility in the equity markets will increase. 2010 had its moments- concerns over Greece, Ireland, Portugal and others led to some significant increases in volatility. We don't anticipate that the Euro is free and clear of these issues which will be reflected in increased volatility in both bond and equity price movements. Close to trillions of Euros are either coming due or required to be financed in mortgage backed bonds, bank financings and regional governments throughout the Euro zone this year. While the largest of the Euro zone countries- namely Germany – is under continued duress to lead and possibly rescue the weaker links, they will not be able to do it alone. If Euro and international lenders don't come to the financing table, the markets will quickly reflect this uncertainty and possibly push emerging superpowers such as China into a more visible supporting role. Also we anticipate that commodities will continue to strengthen- for at least part, if not all, of 2011, however, if they move too quickly to the upside this will most likely restrain if not arrest growth in many economies- particularly the United States. While the Obama government and democrats have moderated their tone after mid term elections, if both sides of congress don't work to cure the US economy, the US economy may lose momentum. Despite continued improvement in the equity markets, these concerns may lead to increased volatility in 2011 versus 2010.

Commodity prices may over-heat, be cautious. In at least the short term, 2011 will see higher commodity prices. In 2010 most, if not all, commodity prices improved. Gold reached an all time nominal high as did silver. Copper – probably one of the best indicators of economic demand among all the commodities – was particularly strong, especially in the last quarter of the year. While some of this strength is due to a weaker US dollar, increased economic demand and investor demand (namely Exchange Traded Funds) has also been a strong contributor to the price strength. But these prices will not go upward in a straight line in 2011. Higher prices without economic growth are not a good long term scenario. Gas prices are going up but if individual income doesn't compensate for the variance, we have less to spend on other items. This means economies will suffer. Again, we feel commodity prices will improve in the early part of 2011 but the higher and faster they go the more cautious we will become. While we have been positive on gold prices for some time we are not as positive going forward as other commodities. We believe that gold has been a reserve currency and in particular has attracted many investors too fearful to venture into equities- particularly those who were most fearful of a double dip. But as these fears abate gold will lose some of its lure and given that gold, like most commodities, provides little additional utility, investors will find more traditional investments more attractive.

Mid and Long term bond returns will struggle to keep up with equities and may be cash equivalents. Bonds markets are already reflecting higher interest rates despite the US central bank initiating another round of easing. China and other countries have already increased interest rates so bond investors must be careful and assume that even without substantial economic growth, rates will continue to move higher in 2011. If major economies such as the US are stronger than presently anticipated in 2011, bond prices will fall even further. Only under extreme cases of high inflation or high growth will cash return be superior to bonds but investors should be wary that bonds may be far riskier than they realize. Cash returns are still meager but they are moving up with interest rates and it won't take much upward pressure on rates to see returns from both asset classes converge.

Thus we come back to our ongoing message- stay the course, invest primarily in conservative dividend paying stocks and prosper.

Thank you for your support in 2010.

Stodgell Investment Management Ltd.