Review and Commentary - 2011

It has been quite a year. It started with a slow rebuild of confidence and a decent rebound in equity prices only to be quickly undone as major economies around the globe started to unwind. The Eurozone, while a difficult and complex matter is still in the throes of sorting itself out. In August of 2011, US politicians appeared to be willing to have their financial system shut down rather than compromise and agree to a deficit increase. A nuclear disaster in Japan, rolling protests of the Arab Spring, 'Occupy Wall Street' , the killing of Osama Bin Laden and the early death of one of the world's greatest technological innovators, Steve Jobs, marked a year that won't be easily forgotten- though many investors will try. We live in an era of instantaneous news and people's general heightened awareness of everything that can go wrong; it is hard to imagine that all the potential bad news isn't already factored into the equity markets. As Jon Birger of Fortune Magazine recently wrote "…there is no shortage of fundamentally attractive stocks to choose from- just a shortage of investors willing to own them."

Last year's predictions were…

Volatility in the equity markets will increase. Well this certainly was true. While the US markets remained virtually unchanged, (SP500 anyway) the Dow Jones was up or down more than 400 points in a day more than any other time in history. A Bloomberg study stated that in the month of August alone the SP500 had daily swings averaging 2.2% - the most since 1932. The TSX was up 6.6% within the first quarter of the year only to fall almost 25% to a low in October then to rebound just over 10% from these lows to end the year with a loss of 11% before dividends. Canada's index, more closely tied to commodities was weaker as cyclical stocks were under pressure particularly in the latter half of the year. We had suggested that commodity prices may overheat in 2011 which should lead some to caution but, like the equities, they were volatile even beyond our expectations.

Commodity prices may over heat, be cautious. "In at least the short term, 2011 will see higher commodity prices" we stated last year. Certainly by the third quarter most commodities retraced from annual highs. In gold's case, it retreated from an all-time high in nominal dollars in September. Copper gained only marginally from its 2010 highs but fell back with most other metals in the late summer, early fall. Falling commodity prices were caused by several factors in the latter half of the year- among them Eurozone uncertainty and economic weakness, an orchestrated soft landing by the Chinese economic authorities as well as the strengthening of the US dollar.

Mid and Long term bond returns will struggle to keep up with equities and may be cash equivalents.
We were quite wrong with this prediction. While equity indexes in the US markets faired relatively and nominally much better than those in Canada, US bonds did outperform though only marginally in some cases. In Canada, however, the TSX/SP equity index was negative while bonds made superior returns. The US Federal Reserve maintained a low interest rate policy and will continue to do so until the US economy gains some meaningful traction. With weakness in the Eurozone and a slow- down in China, interest rates around the globe fell making US and Canadian bonds more attractive.

Predictions for 2012….

Equities will provide positive returns for North American Investors and unlike 2011 perform better than bonds. As they say in gambling circles, we are doubling down on this one. The majority of investors remain on the sidelines. According to a report on CNBC, $450 billion dollars have been withdrawn from US equity funds while over $850 billion have been invested in fixed income funds. With interest rates at all-time lows, cash levels in corporate coffers close to $ 1.4 Trillion dollars, increased dividends, buybacks and decent equity valuations, this tide will eventually reverse. The uncertainty of the markets may make timing uncertain but eventually the potential risk –reward will tip so heavily out of the fixed income markets that investors will come back to equities. Plus, even while the world is in the midst of turmoil, it is universally accepted that the global economy will grow. Imagine if it grows slightly better than expected. Will China ease after it appears it has successfully engineered an economic soft landing? What would happen if either Obama became more business friendly or possibly a Republican candidate replaced him in the White House later this year?

While the Eurozone issues may require more drastic measures, it will be resolved but only after the markets push the politicians to act. Much like equities, the volatility surrounding this issue will be significant. While a quick resolution seems unlikely given what has been achieved in 2011, market forces may be required to impose the necessary changes if various parties defer. While the Eurozone may end 2012 differently than when it started, it will survive. As we have stated in previous correspondence we wouldn't be surprised if China participated with some kind of financial support; they have a vested interest in maintaining the relative strength of the currency given it will lessen their dependence of the US dollar in terms of diversifying their enormous currency reserves. Ongoing unrest and turmoil in the Middle East may add further to market volatility which may (hopefully) force the US to get more serious about becoming less dependent on antagonist suppliers of their energy and vital resources. This indeed would benefit Canada.

China will successfully engineer a soft landing. Recent evidence suggests that their economy is stabilizing. In December 2011, the PMI (Purchasing Manager Index) in China rose to 50.3 from 49 in the preceding month while the median estimate was 49.1. Inflation is coming down thanks to lower commodity prices. Predictions regarding world economic growth are varied but we believe that the Chinese and Far Eastern economies will continue to grow and bring along with it renewed demand for commodities and raw materials. As much as the Chinese were successful in slowing their economy in 2011 they may attempt to be equally eager to reignite their economy if it fails to turn on its own. While there will be worries about housing prices and bank loans, China is at the start of an industrial resurgence that may take decades, not years, to fulfil. The US economy, as we suggested in previous writings, did do better than most predicted and they along with China can provide a significant catalyst to resource prices and resource rich economies such as Canada.

Stay the course, invest conservatively and prosper.

Thank you for your support in 2011.

Stodgell Investment Management Ltd.