

March 2011

Overview

## **I**N THIS SECTION WE TAKE A LOOK AT A FEW NOTEWORTHY ITEMS THAT HAVE COME TO THE FORE OVER THE PAST FEW MONTHS.

Some readers will recall the ascendancy of **Japan** in the 1980's to 'king of the world' status when everything Japanese, from education to culture to business, was considered the epitome of excellence by the rest of the world. Westerners made supplicant-like pilgrimages to Tokyo to discover The Way. With this history in mind, we read with some sense of irony that Japanese government debt had been downgraded another ratings notch, thus adding one more step to Japan's Great Descent in the intervening years. We don't recall many contrarian voices back in 1990, but this massive reversal reminds us that the sceptical view can be a valuable one.

**Copper prices** have skyrocketed from their bottom in early 2009, supporting the Dr. Copper designation once again as economic forecaster extraordinaire. At its current price of about \$5 per pound, copper has also become a theft target as wire, pipe and tubing look pretty valuable when melted down. What about our hoard of pennies, you ask? The answer is bad news, good news and bad news. It turns out that today's 'copper' pennies are actually mostly steel with a copper coating. However, pre-1997 pennies are 98% copper and it takes 186 of them to make a pound, a pretty good investment at \$5 copper. But apparently it's illegal to destroy

currency so better not get out that melting pot just yet.

If you time travel back to March of 2009, when the news was bad enough to make the end of the world a realistic prediction, you might not have expected a **booming stock market** to ensue. In fact, though, that is exactly what happened with the big gains punctuated in February by an official doubling of the S&P 500 from that bottom. Even more remarkably, this doubling is the fastest such gain in history, beating the previous record by nearly one full year. Amazing.

When you hear all the talk about high consumer debt levels it seems a little odd to read that the **net worth of Canadian households** is at a record high. According to Statistics Canada this is in fact the case, as household assets (real estate, stocks, bonds, pensions etc.) less all associated debt (mortgages, credit lines, credit cards, etc.) equalled \$6.1 trillion at the end of September. This means that all the net worth lost in the recession (\$550 billion) has been regained and then some. Quite a feat. In the U.S. the comparable net-worth figure stands at about \$55 trillion and, while rising, is not back to previous highs due to still-weak housing prices.

One of the main reasons for stock-market gains over the past two years

has been the **strength in corporate earnings**. Generally these quarterly reports have exceeded analyst expectations, which is a positive condition for investors. But we wondered if such expectations were getting out of hand when we read this commentator's review of Visa Inc.'s earnings report: "It failed to beat expectations by as much as investors have come to expect". Huh?

**Rats cause grain prices to rise.** We were surprised to hear that too, but were relieved to learn the little rodents haven't cornered the commodities market. No, apparently rats affect prices by restricting supply as they reportedly gobble up 20% of the world's annual grain crop. Bring on the cats!

If you have seen the movie The Social Network or are a dedicated Facebookie yourself, you will be well aware of the **Facebook** phenomenon circling the Globe. According to the company website, Facebook now boasts over 500 million users who, incredibly, are socializing online for 700 billion minutes a month or an average of 23 hours per user. Is this how technology makes us more productive? However, 70% of the members are outside the U.S. and some of those used the site to foment revolt in Egypt, proving that technology can be used for surprising purposes.

## THE LEARNING CORNER

### What is QE2?

No, for all you cruisers out there, it is not a boat. But it is, in a sense, a boatload -of cash- that some people worry could be akin to the Titanic. The QE in question stands for a quantitative easing program the Federal Reserve Board (and Bank of England) has embarked on and the 2 identifies it as their second shot by this means at supporting economic revival. While the mechanics of QE are relatively simple (the Fed 'creates' money electronically and uses it to buy bonds from financial institutions), the ramifications are anything but.

The main goal is to inject cash into the banking system, which ideally would use the funds to lend to borrowers, thereby expanding the money supply

and, eventually, the economy. As well, such easing should help to keep interest rates down, combat deflationary pressures, create a positive wealth effect via the stock market and, importantly, send a confidence-boosting message about central bank support. Of these objectives, the stock market has been the most obvious beneficiary so far. This all sounds good, but there are critics as suggested above. They claim it is a desperate measure based essentially on printing money, which will lead to excessive inflationary pressure and the economic headaches that inflation creates.

Which side is right? We can't claim to know the answer when even great economic minds disagree, but our sense is that the economy would still

be in expansion mode without this kind of support, thus making it an unnecessary risk. Still, there is significant slack in the system, especially in the labour market, which creates an underlying deflationary influence even though food and energy prices are rising, so we understand the Fed's concern. We are left to follow the old investment adage which says "Don't fight the Fed" and count on their wisdom to end the easing when promised (by June) and eventually reverse course (sell those bonds), as promised. If they follow through, it's not 'printing money'.



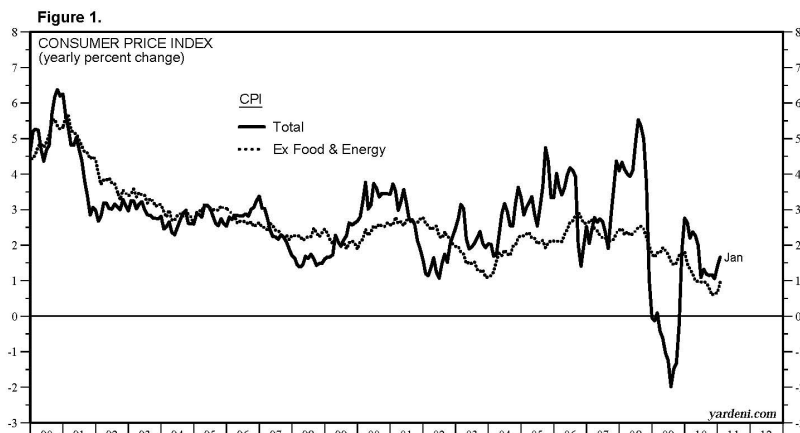
## CHARTING OUR TIMES

There has been a lot of talk about building inflationary pressures in the United States as a result of the Federal Reserve Board's attempts to boost economic activity (see The Learning Corner). So far, though, the accompanying chart showing a 20-year inflation history in the United States presents a pretty benign picture. The chart shows inflation levels for both the total consumer price index ('headline' inflation) and for so-called 'core' inflation, which excludes the volatile food and energy components. Because food and energy prices are largely unrelated to central-bank policies, it is this latter series that central bankers tend to target when considering the impact of their actions.

While the total CPI history has been more volatile, both series have been in a long-term downward trend. The pictured decline would be even more evident if the chart extended another 10 years or so to the time when inflation peaked at around 13% in 1981. Those were the bad old days. Interestingly, both series are currently running below the 2% level deemed manageable by the fed and the numbers in

Canada and other developed economies look similar. It is likely that the downward move came largely from supportive central-bank policies (they learned from the 1970's experience) and increasingly cheap technology but it is fair to say that globalization and its attendant surge in world trade and competitive forces helped to control prices as well.

That global competition is still a big factor in companies' pricing decisions as there are countless entrepreneurs out there, both big and small, developing better products at lower prices. This means supply is expanding, yet cost pressures remain modest as most economies continue to operate at well below capacity, especially on the labour side. As well, central bankers remain vigilant and technology has barely scratched the surface of its massive potential. Yes, price pressures will build from time to time, and we could be entering one of those periods now with food and energy leading the charge, but long-term prospects still seem pretty reasonable.



## IN THE OFFICE

At RaeLipskie, we believe in giving back to our community. Our staff does this through various volunteer activities such as Habitat for Humanity, Manulife Bike and Hike for Heart, being members of Rotary groups, CFUW-KW, Junior Achievement, etc. As a firm, we also do our part to support charities in the community. We do this through direct donations, but also through our spring luncheon (see information below) and through rebates on the fees paid by the 24 charities whose portfolios we manage. Every quarter, we donate 25% of the management fees to our charitable clients to support their activities. Last year, this figure amounted to over \$60,000.

Speaking of our spring luncheon, this year, on Tuesday, May 17 at Westmount Golf & Country Club, we are pleased to have Alan Morgan, a retired UW professor, talking to us about climate change. Donations will go to Bird Studies Canada. Invitations with more information will be mailed to you closer to the date. Congratulations to Heather and her husband, John, who celebrated the birth of their son, Clarke Winston John Dewar, on September 11, 2010.



We would like to take this time to remind you that you can help save a tree by having your newsletter emailed to you. If you would like to receive your newsletter electronically, please contact us at 519-578-6849, or toll free 1-888-578-7542, or via email at:

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## THE BIG PICTURE

World economies are gaining traction, it appears, including those in Canada and the U.S. Both manufacturing and service industries have boosted output, international trade has mushroomed and shoppers are returning, if not in droves then at least in moderate numbers, taking many economies back to pre-recession levels of activity. For those economies this means a shift from recovery mode to expansion status and a marked lowering of double-dip recession concerns.

This is not to say we are in a trouble-free environment of course. We know all too well that debt levels in many jurisdictions appear excessive and will eventually require hard decisions and further economic growth to bring them into balance. There are glimmers of light at the end of the U.S. housing tunnel but that important sector remains fragile. There is still substantial economic slack, especially on the labour side, and that should keep core inflation controlled, but food and energy prices are problematic for the overall consumer price index. Potential inflation flare-ups and stronger economic activity may well push interest rates up somewhat, creating concerns about sustainable growth if rates were to jump too high. As well, as we have witnessed recently with the political events in North Africa and the Middle East where anti-despot rebellions have sprung up unexpectedly, the financial system is always prone to surprises, the ‘unknown unknowns’ in Donald Rumsfeld’s terms.

When it comes to the stock market, this is where we roll out the age-old adage that a strong market always climbs a wall of worry. That is to say investors are

forward looking and are willing to look over the valley of concerns as long as the risks are appropriately factored into stock prices. To balance those risks listed above, we have stock markets that are still below their highs of three years ago; corporate profits that are growing to previous high levels; parameters such as price-earnings ratios and dividend yields that suggest still appealing valuation levels; very low interest rates available on bonds that make stocks look even more attractive in comparison; supportive central banks; and lots of dollars now invested in secure but low-return investments that have started to migrate to the stock market. This doesn’t make the stock market a comfortable decision, but then no one ever claimed it would be easy.

### QUOTE of the DAY

**“There are decades when  
nothing happens; and there  
are weeks when decades  
happen.”**

*~Vladimir Ilyich Lenin*