The Rae Lipskie Partnership™ | Private Wealth Management

September 2011 **Overview**

To characterize recent market activity as volatile would seem to exaggerate the importance of the word. After all, volatility is the norm in the stock market, a condition investors expect to grapple with on a day-to-day basis and learn to live with, albeit uncomfortably at times. But these days of multi-hundred point declines, apparently reflecting the end of the world and followed immediately by similar sized gains which seem to equally assure coming prosperity, surely should fall under the aegis of a more robust description than the simple 'volatile'. We can get adverbial support all the way from 'very' to 'extremely' but a single word to capture the true tone of the market eludes us. On some days, though, bizarre would be a fitting description. Or maybe insane.

We hesitate to remind readers of the August mayhem, but an example of the above would be the six straight trading days early in the month when the Dow Jones index moved at least 400 points from top to bottom, or vice versa. The biggest day was 640 points and the average action over the six days was 549 points between high and low, about 5% per day. If that 5% per day figure doesn't impress, think of it in the context of a 5-year Canada bond that pays 1.5% per year. This calculation does not even count the sometimes huge intraday ups and downs which would add considerably to both the point total and the 'volatility' factor. Meanwhile, we more docile Canadian investors only managed to move the TSX index a daily average of 477 points over the same period, a relatively placid action that translates to just 4% per day.

There are always reasons, of course, for such furious trading activity as otherwise the ubiquitous talking heads would be without jobs. Headlines told us one bad day was due to a currency war (Japan and Switzerland discouraging cash inflows…who knew you could have too much cash?), another because of the admittedly political U.S. credit downgrade and yet another owing to rumours that France was next on the downgrade list and that big French banks needed bailouts, such rumours later reported to be 'unfounded'. The same headlines claimed up-day rationales of the Fed 'locking-in' low interest rates for an extended period, positive jobless-claim numbers, better corporate earnings than expected and then, of course, the always available 'bargain hunting' by investors. At one point, even Mr. Warren Buffett entered the fray with his soothing words of value for bewildered investors.

However, these are just headlines. Obviously it takes real people to buy and sell, whether they be investors, speculators, day traders, high-frequency traders or what have you. They are the ones who continue to hammer a stock when it has already been pounded that day or, on the good days, buy it when it has already soared. All of this frenetic activity does make you wonder, though, who is running the asylum. We know that hedge-fund managers will change position on a dime and they can be absolutely brutal traders in executing the change. We know that high-frequency traders have become a big factor in all markets with their millisecond time horizons and massive volumes. We know that exchange-traded funds have mushroomed in popularity, giving traders high-volume vehicles for short-term activity. We know that today's uncertain environment is conducive to skittish investors with short time horizons.

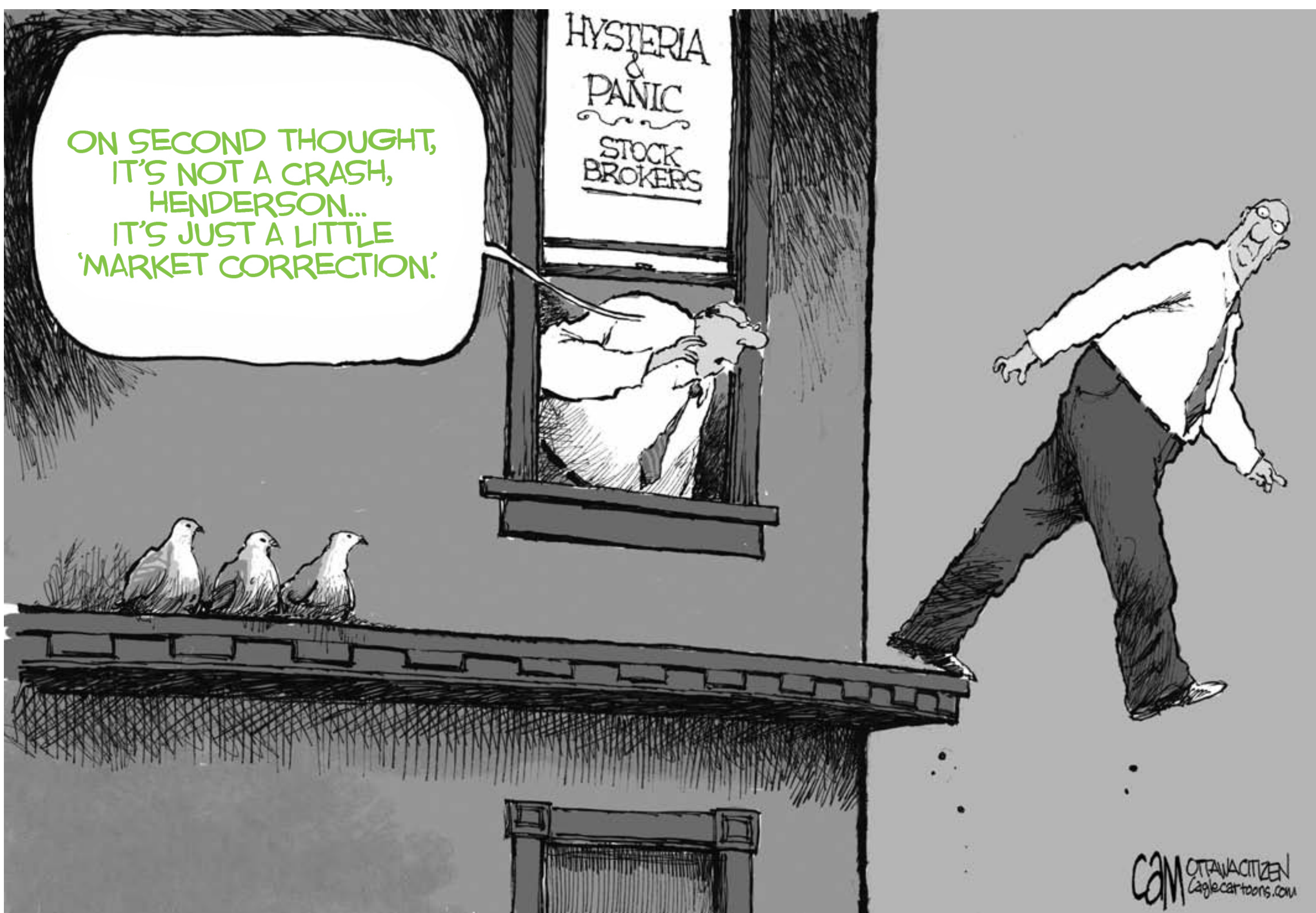
Knowing all this, as long-term investors it still surprises us to see such a short-term mindset create such chaotic conditions in a market which, by its very nature, should arguably take the longer view. And, while we still don't have a better word, the intense volatility and its questionable rationale re-emphasize for us the futility of short-term trading and the importance of a sound investment program.

THE LEARNING CORNER

What is high frequency trading (HFT)?

Computers have long been important tools in formulating investment strategies and in formatting trading approaches. In recent times, the sophistication level of computer-based trading platforms has grown dramatically along with the muscle of enhanced technology and the brain power of computer programmers. This powerful combination has hatched a new class of investors (speculators? computer jockeys? androids?) who are now known as high frequency traders. The name comes from the fact that these traders, set up with banks of computers programmed with complex algorithms for data analysis and trading, are constantly moving huge volumes of shares over extremely short periods of time. Often investments are bought and sold in milliseconds with profits measured in a fraction of a penny per share. It is claimed that such activity makes up well over half of all volume on many major exchanges.

This rapid-fire trading approach is controversial and its impact on the market and the attendant volatility is hotly debated. Proponents claim that these trading programs provide increased liquidity to markets and can actually stabilize a panic situation while others, probably the majority, charge that HFT is inequitable, manipulative and a primary cause of the unnerving volatility. The Securities and Exchange Commission found that HFT "exacerbated price declines" in the Flash Crash of May 2010, when the Dow dropped 600 points in 5 minutes only to fully recover in the next 20 minutes. Such evidence would seem to be condemning but no further regulation has yet been enacted.



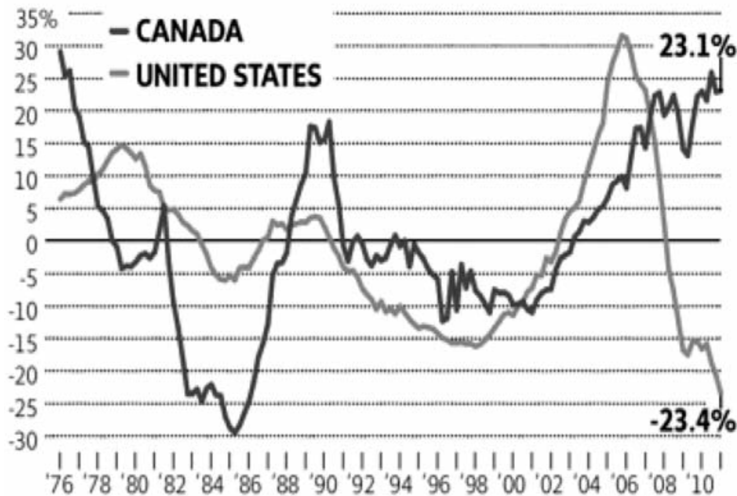
CHARTING OUR TIMES

It is generally agreed that one of the primary contributing factors to the feeling of economic malaise these days is the continuing weakness in the U.S. housing market. It seems every week we hear of another report that shows housing construction, sales and prices still struggling to gain traction south of the border. The Case-Shiller index has prices down over 5% in the past year and a whopping 32% off their peak in 2006. Meanwhile, and possibly perversely, our housing market in Canada remains quite buoyant on all those same fronts, with the Canadian Real Estate Association reporting that national prices are up over 9% in the past year to record levels in most markets.

The chart below presents a somewhat different view of the huge disparity between the two markets, this one based on valuation. It shows the prices noted above compared to personal income and relates the result to historical averages in both markets. On this basis, the chart's conclusion is clear: prices in the U.S. are historically cheap relative to the average buyer's ability to purchase, exactly the reverse of the situation in Canada. We are far from expert in housing matters but the value investor in us suggests the U.S. market has a lot more potential for growth than in Canada.

HOUSING NEARING A BUBBLE?

House price to income per capita, percentage deviation from historical average



SOURCE: CAPITAL ECONOMICS

IN THE OFFICE

We are very pleased to welcome Jim Harper, FCA, to the RaeLipskie family. Jim recently retired from BDO Canada, where he had served in various management positions within the firm including Chair of the National Policy Board and Waterloo Region Managing Partner, but still wanted to remain active in the business world, just in a different capacity. He will be our Director of Marketing and Client Development.

Jim is incredibly involved in our community, serving on boards such as St. Mary's Hospital Foundation and Board of Trustees, The Cambridge & North Dumfries Community Foundation, Sandra Schmirler Foundation, Junior Achievement of Waterloo, University of Waterloo, and The Greater KW Chamber of Commerce among many others.

To relax, Jim enjoys golfing, reading political and history books, travelling, enjoying his cottage in Muskoka, and spending time with his wife, Pauline, his two grown children and his four grandchildren, soon to be five!

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We congratulate our receptionist, Ashley Cooper, and husband Blake on the birth of their first child, Alina Ann Cooper. Everyone is healthy and happy!

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,

Telephone: **519.578.6849** | Toll Free: **1.888.578.7542** | Email: **reception@raelipskie.com**
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THE BIG PICTURE

The economic recovery that started over two years ago was never expected to be a barn burner relative to past growth rates coming out of recessions. This subdued expectation was mostly due to the overhang of debt, especially in the consumer sector where shoppers didn't have the capacity to boost economic growth through borrowing the way they did in the past. Because the consumer is so important to the economy, making up about two-thirds of GDP, this factor was bound to be a drag on recovery prospects. The slow improvement in jobs and housing remaining in the doldrums did not help. Still, the recovery moved into expansion mode, led by developing economies, with several quarters in the U.S. near the 4% real growth level, taking that behemoth to the remarkable $15 trillion area. (This is a good number to keep in mind, for perspective, when thinking about debts and deficits.)

It turned out that this was a pretty good environment for financial markets. Industrial production and world trade provided growth but not so much as to raise overheating concerns… a Goldilocks environment. The combination of modest inflationary pressure, manageable credit demands and central bank support kept interest rates down and bond prices up. Low interest rates, ample liquidity and, most importantly, strong corporate profit growth powered stock markets to big gains.

Now the prospects for continued economic advances are under question again as the old bugbears of debt, housing and jobs still stalk the economic landscape. Growth rates have dropped, including a small contraction in Canadian GDP in the second quarter. So the debate rages: Is this a normal mid-cycle slowing or a slippery slope to re-recession? We are inclined to the former as many of the positive factors remain in place, including low interest rates, promised for some time to come, and robust corporate financials and profitability. Add to these the expectation that a strong corporate sector will eventually be in expansion mode, assisting employment prospects; the notion that consumers have retrenched into a stronger state so that borrowers and lenders will be talking again; and the likelihood that U.S. housing will be bottoming given the above supports plus compelling pricing. Worries remain, of course, and always will, but moderate growth still appears the most likely scenario.

QUOTE of the DAY

Question: How many people work in the Greek civil service?
Answer: About half of them.

~ Anonymous

We are:

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Rae & Lipskie Investment Counsel provides discretionary "fee-only" portfolio management for high net-worth individuals, endowments, and charities.

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