

Mutual Success

Your Fund of Information



May 2010

Emerging Themes of the Year

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Last quarter, we wrote about the psychology of investing and the cycle of emotion. At this stage, we believe that we are past the stage of optimism and closer to the Euphoria stage. Our reasons for believing that we might be in a late stage of a market rally are both anecdotal and objective. Anecdotally, the April Cover of the Newsweek cover states “AMERICA’S BACK”-see figure 1. Sentiments appear generally bullish, most market advisors are bullish and newsletters are leaning bullish. Most fund managers are bullish, judging by the low amounts of cash holdings in their. In US, the average level of cash holdings has dropped to 3.5%, a level that was reached in the summer of 2007 at the start of the market declines.

Objectively, average stock valuations have again reaching the giddy Price Earning (PE) ratio of 23.39. At this level any unexpected economic or geopolitical news may have a significant downward pressure on the market. Our overall perspective is that, while this euphoria could last some months, we remain concerned that the huge rally from last March’s low could still be part of a bear market rally.

Our concerns are founded on a few emerging themes.

1) Government’s Indebtedness:

Governments the world over embarked on huge stimulus spending and financing programs to prop up their financial institutions and economies over the last year. In the process they incurred large debts and unsustainable fiscal deficits putting significant pressure on their national balance sheets. While much is made of the financial woes of Iceland, Greece, Italy, Portugal and Spain, G8 countries including Japan, USA and UK are also facing real issues. Coupled with their high public debt as a percentage of GDP, these same countries face an uphill task to get their finance in order.

A recent OECD study reflects that all of these countries are operating below their “Line of Safety”, based on the conventional measures of indebtedness and productivity – see figure 2. Like families that have overspent on their budgets and need to roll-over their credit lines, these governments will face an uphill task in getting refinanced. Traditionally, financing is done through the issue of sovereign or government debts backed by taxation authority of the state. However, international and private investors are getting wary and worried about these nations real ability to service their debt. As an example, we have seen Greece recently having trouble financing their debts and having to resort to outside help and internal austerity measures.

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With IMF support the immediate challenge is allayed but structurally, the problem remains.

In the case of the US, the Chinese and Korean governments then have historically been happy to invest their trade surpluses with the US back into US Treasury Bills. However the weakening dollar and low interest rates are encouraging them to look elsewhere. As other governments and large investors adopt a similar stance the US is facing the prospect of having to print more money which fuels the devaluation of the USD and primes the inflation pump. The US Fed has indicated that it will continue to hold down interest rates due to the fragile state of the recovery which fuels our concern that "America's Back" may be a premature statement like "Mission Accomplished"!

2) Inflation and Rising Interest Rates:

Australia and Canada have already signaled that they see inflation as a problem and pressure is now on to raise short term interest rates to prevent runaway inflation. Rising short term rates will also have a tendency to pressure long term rates upwards. This upward pressure on long term rates is further fuelled by the concerns over the ability of governments to service their debts and risk premiums are rising. Part of the protection for clients in this market is to shorten the duration of bond maturities and hold real return bonds and corporate bonds where the higher risk premiums are already factored in. Uncertainty around government bond ratings will significantly restrict the ability of central banks and governments to print their way out of another significant downturn.

3) Government withdrawal of stimulus:

Learning from the Japanese lesson of dealing with post property bubble crash, the US government has stepped up by pumping money into the economic system to replace private individuals and corporations that are in the process of deleveraging. The process of deleveraging involves a repayment of debts from savings and corporate profits with less left for new purchases and investments. This results in lower

aggregate demand for goods and services. In Japan the Government was able to prop up the economy for many years before deleveraging was completed. The US faces a similar challenge from deleveraging, as evidenced in continued negative statistics for the US housing market and unemployment figures. Despite the floodgate of stimulus measures taken by the US Government, the effects on these two areas remains weak. In our opinion, the US is currently not in a position to quickly withdraw their stimulus programs.

4) Emerging Markets and the Commodity Based Economy:

The rising Asian and commodity-based economies like ours continue to enjoy a quicker recovery vis-à-vis other developed nations like the US and European countries. Canada has emerged from the stock market crash as one of the strongest, in terms of the banking and housing sector, positioning itself as one of the go to place for new investments. Our sovereign debts, like Germany and other surplus nations such as Asian countries, Australia, and Switzerland, are in better standings and in demand. Coupled with a potential higher interest rate and a stronger Canadian Dollar, international flow of funds seeking a safer haven currently view Canada as one of the best places to invest. Even our Government has been promoting our financial model as the strongest in the world and suggests that a stronger Canadian dollar will not have much impact on our export competitiveness.

In light of the above emerging themes, what are currently the best strategies?

We continue to seek ways to improve and enhance our fixed income holdings by recommending going into Real Return Bonds, High Yield Bonds and other Inflation Protection Funds. To cope with the higher taxation of holding fixed income, we continue to seek tax friendly funds such as FlowThrough Limited Partnerships Trusts. The market is likely to continue to be volatile, trading in a wide range due to the above factors that are creating uncertainties. We view volatility as an opportunity to increase exposure to certain sectors of

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the equity market when market values create opportunities. In terms of Equity investing, we continue to recommend overweight Canadian versus Foreign equities in light of our relative economic strength. The sector we continue to have exposure to is the precious metals and material/energy/resource sector. As we know, investment forecasting is difficult, as it involves a prediction of future events. However, we can take a proactive approach to preserve and increase investment value at the appropriate risk level for each client.

Best Regards,



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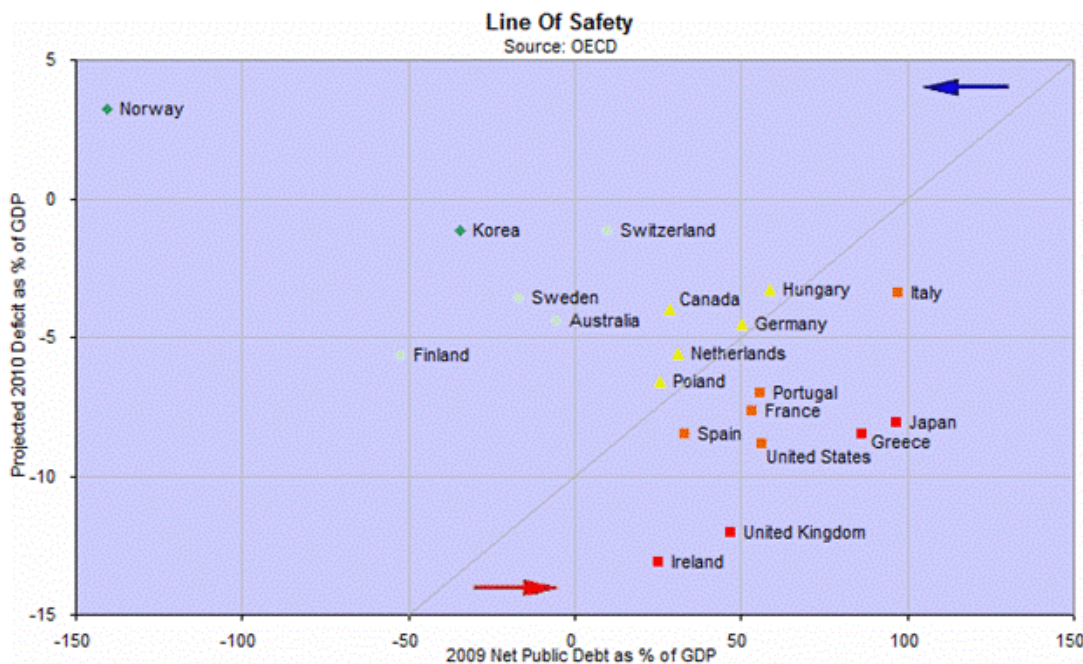


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Figure 1



Figure 2



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