

Financial Foresight

Dempsey Investment Management • Spring 2010 Edition

Going for “Gold” in Canada

With the Vancouver Olympics still fresh in my mind, I was curious as to what opportunities Canada may present to investors looking to win in a very competitive environment.

With a population of about 34 million, vs. around 310 million in the US and slightly more land, Canada is one of the world's wealthiest and yet least densely populated countries in the world. For investors looking for a way to benefit from growth in China & India we many not need to look much further than our neighbor to the north. Canada owns a vast wealth of natural resources, used in products and materials to support growth around the world.

Did you know that Canada is America's largest supplier of crude oil, accounting for 23.9% of our imports?¹ Most developed countries are importers of energy while Canada is one of the few that are net exporters of energy. Canada has the 2nd largest oil reserves in the world after Saudi Arabia. In addition to oil, Canada is a large producer of zinc, gold, nickel, aluminum, lead, and timber. It is also the world's largest producer of uranium. Uranium is going to be critical to fuel the construction of nuclear plants being built around the world. Whether you believe in global growth or are concerned about a weaker US dollar, these types of commodities can do well in an inflationary cycle and may be a good hedge for your investments.

We keep hearing about our national debt of \$12.5 trillion and projected yearly deficits of over a trillion dollars. The US is not alone. Greece, Ireland, Spain, UK and Portugal are all having serious budgetary problems. You most likely have not heard Canada mentioned on news reports. Canada does have debt and is currently running a deficit but their numbers seem much

more manageable. Reviewing davemanuel.com, I saw that Canada's national debt clock was at \$513 billion, or \$15,464.87 per Canadian.² This compares favorably to our debt of \$12.575 trillion, or \$41,391 per American. While we seem to have no chance of paying off our debt, Canada has some positive numbers and projections. The US has increased its debt more in the first three months of 2010 than Canada has accumulated over its entire history. Looking back in time, Canada had ten consecutive years of budget surpluses through the 2006-2007 fiscal year. Over the last few years, the global recession has created deficits; however, a return to a growing economy could bring back the surplus, debt reduction and a stronger Canadian dollar.

One area that did not get hit, relative to the United States, during the recession was Canada's banking system. I looked at the following banks: Bank of Montreal, Bank of Nova Scotia, Royal Bank of Canada, and Toronto Dominion, and compared them to Bank of America, Citigroup, Wells Fargo, and JP Morgan.* While looking back over a 3-year time period of 03/13/2007 through 03/12/2010, I found the low point to be in March 2009. Around this time, the average of these Canadian banks lost 67.46% from their peak during that three year period. This compares to 86.41% for the four US banks. By mid-March of this year, many Canadian bank stocks had rallied back to within an average of 11.21% from their high, while these US banks are still 50.95% below their high. In addition, the Canadian banks did not cut their dividends while these four U.S. banks cut theirs an average of 91.87%. Apparently, the banks north of the border were being run more conservatively and did not have to go to the government for bailouts.

Over the last ten years through 02/28/2010 the S&P TSX (Toronto) Composite has averaged 8.05% compared to -0.31% for

the S&P 500. While past performance is no guarantee of future performance, if you believe the future is bright, how do you take advantage of the Canadian market? There are some exchange traded funds worth looking at: iShares MSCI Canada (EWC), and Claymore Energy Income (ENY).* EWC is more broadly diversified, with a concentration in financials, energy, and materials. ENY is riskier because of its sole focus on energy. You could also look to open and closed-end mutual funds that target Canada. Also available are Canadian companies trading on the US exchanges and Canadian trusts which are typically known for their high dividend yields. (There are some important tax changes in store for trusts that will likely cause many of these trusts to convert to corporations.)

As always, it is very important to be diversified. If you are interested in investing in Canada, allocate a small piece of your portfolio for this. While Canada did win the gold in hockey, they can't win it in all areas. A well diversified portfolio will reduce your risk. Please contact me if you would like to discuss your portfolio.

**The noted stocks and funds are added for informational purposes, not recommendations.*

¹Crude Oil and Total Petroleum Imports Top 15 Countries," U.S. Energy Information Administration <http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/company_level_imports/current/import.html> (11 March 2010).

²Canadian Debt Clock," Dave Manuel.com <<http://www.davemanuel.com/canada-debt-clock.php>> (11 March 2010).

Save the Date!

Please join Don Dempsey of
Dempsey Investment Management and Richard
Romey and William Koehler of
ETF Portfolio Partners
for a live webinar on

Friday, April 30, 2010, 10:00 a.m.

More details will follow shortly.

Ben's World: Is Fed Chairman Ben Bernanke a "Maestro" Managing the Nation's Money Supply or Inflating the Next Bubble with Easy Money?

By William E. Koehler, CFA
ETF Portfolio Partners

"You can observe a lot just by looking around," once said the eminently quotable former New York Yankee Hall of Famer, Yogi Berra. We like Yogi's philosophy in analyzing markets. We spend a lot of time observing actions (and discounting words) as we evaluate the global capital markets.

The big observation in the current environment is Mr. Bernanke's decision to keep short term interest rates extremely low. Unlike long term rates, which are set by market forces, short term rates are controlled by the Federal Reserve Bank, the central bank which serves as the "bankers' bank." These low rates are currently the bane of savers and a boon to the bankers. Bankers are able to borrow from the Fed at very low rates and then lend, if they are lending, at higher rates or simply buy government bonds yielding 4%. Savers are scrambling as they try to find CDs and money market funds that pay some kind of modest return.

Why the low rates? It is a function of the bursting of the housing bubble. We believe Ben's low rate policy is designed to "cushion the blow" to the banks from bad real-estate loans. However, as always, there are unintended consequences. One of these is that Wall Street investment banks, now registered as "commercial" banks, can borrow from the Fed at these low rates and buy assets like stocks. Another unintended consequence of low rates is to push some risk-averse individual investors into more aggressive investments as they search for higher yields. This is seen in investors continuing to pull money out of money market funds and purchase bond funds. Equity mutual funds were in net redemption

in 2009 for the second year in a row. So who is pushing up the prices of stocks? One answer appears to be the big banks, a development that bears close watching going forward.

The answer to the question in the title is "probably neither." Mr. Bernanke had to inject some liquidity into the financial system over the last 18 months. At the same time, we also believe he must remember that markets have natural healing powers. Consumers, businesses and investors adjust. In light of this, from a portfolio strategy perspective, we are incorporating three themes into our client portfolios: more quality growth, more international and more income. Our current portfolio strategy has incorporated this easy money theme over the last twelve months. The economy remains less than sustainably robust, particularly consumer spending. Housing inventories are coming down, but will need at least another year to be worked down to more normal levels.

Our strategy is to stick with quality, migrating to quality corporate bonds and high quality equities. Unlike the federal government, many corporations, after pruning employees and paring debt, are lean and flush with cash. This cash provides fuel for increasing dividends and making acquisitions. In an environment where ratings agencies are even remotely discussing the notion of the downgrading of U.S. sovereign debt, we think a move toward higher exposure to high quality short to intermediate term corporate debt makes sense. We also like continuing exposure to gold, but in a different form. There is more operating leverage in mining stocks than gold bullion right now.

In the United States, consumer spending will remain constrained. Consumers will remain more practical in their spending and more budget conscious even if the federal government is not. Growth will be slow and labored like an overweight weekend warrior trying to run around the high school track in the spring after being inside all winter. Technically the markets are in an uptrend.

Fundamentally, we want to increase exposure to those areas of the world attracting greater capital flows and demonstrating more economic vibrancy. Therefore, we have increased our international equity exposure to Asia. Many emerging countries have low budget deficits as a percentage of their GDP or even budget surpluses. We expect long term earnings growth of 12% for the emerging markets countries versus 6-8% for the United States.

Conclusion:

"Don't fight the Fed" is an old adage in the money management profession. It means if the Fed is employing an easy money policy by keeping rates low, don't try to outsmart them. Have some exposure to common stocks. We believe there is an element of truth in this saying and that it applies in the current market environment. However, investors have to continually maintain a watchful eye on the Fed. They do not have a magic formula. They are making what they believe to be informed judgments just like every other human being investing in the capital markets. We are carefully looking for clues that would signal an impending rate hike or at least a change in Fed posture. Our attitude is that Mr. Bernanke has done a respectable job, but we would like to see slightly higher short term rates, thus giving the savers a break. An economy growing at a 5% clip should be able to handle at least 1% short term rates. However, that type of Fed thinking appears to be "down the road" for now, which provides support for equity prices over the next several months. In our opinion, fighting Mr. Bernanke and the Fed today would appear to be something better left undone.

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ETF Portfolio Partners acts as a sub-advisor for Dempsey Investment Management, facilitating trading and research, while Don Dempsey works directly with clients for planning and service.