

June 20, 2011

## Rocky Start to Summer is not Beginning of New Bear Market

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Global equity markets are in the midst of another consolidation phase similar to the multi-month workout it experienced last summer. European and U.S. debt problems are coming back into focus at the same time as we exit a second round of quantitative easing. The summer also tends to be a seasonally weaker trading period for the market, thus the adage, “sell in May and go away”. Investors have also taken note of weaker economic readings that may simply be a sign of a mid-cycle slowdown, the result of the Japanese “disaster” and higher energy prices. Despite this growing wall of worry, there are reasons to believe this corrective action in stock prices will be short lived, and the dark clouds will give way to brighter skies later this summer.

### Periods of Consolidation Tend to Follow Periods of Excess Returns

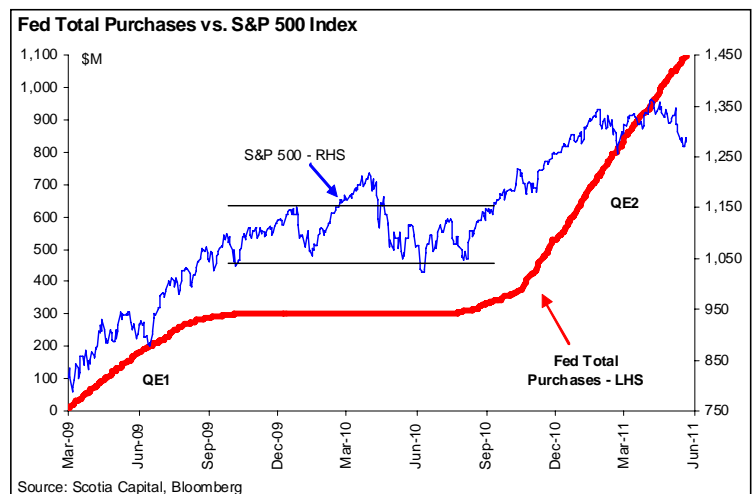
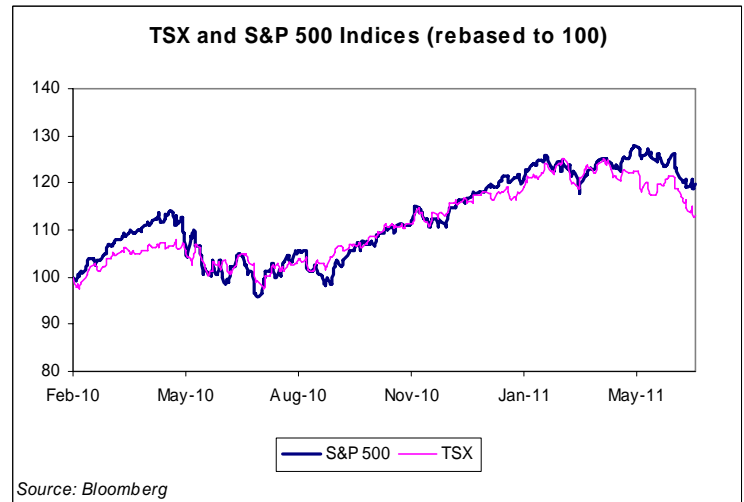
The nine month long rally that saw the TSX Composite and S&P 500 Indices soar 30% coincides with the U.S. Federal Reserve’s decision to enter a second round of quantitative easing. However, this was no coincidence as the Fed’s intentions were well telegraphed; rising asset prices as a means of stimulating spending and eventually job creation. This second round of government sponsored bond purchases is quickly heading towards its conclusion (June 30<sup>th</sup>) and the rally in equities has faded along with it. Quantitative easing was not the only catalyst behind the markets lengthy surge. Corporate balance sheets and profitability have recovered along with the global economy, helping to push stocks higher.

Abnormally high returns ultimately give way to periods of consolidation. This time there are two nagging concerns that will continue to weigh on stock prices as we head towards our summer holidays – the growing sovereign debt problem and weaker economic data.

### Government Debt Weighing on Financial Markets

The sovereign debt crisis affecting peripheral Europe is making headlines again as Greece is forced to accept a second bailout in little more than a year. Yields on Irish, Portuguese, and Greek government debt have spiked to new highs, and this comes despite a European Union “bailout” of all three nations. The yield on Greece’s 2-year bonds recently hit 30%! For perspective, two-year Canada and German government bonds both yield 1.5%.

Core European countries, such as Germany and France, recognize the cost of not supporting Greece is far greater than the cost of bailing them out, so a default, at least in the near-term is an unlikely outcome. If Greece were to default, the risk of contagion following such an event would be high. European banks could suffer significant losses, and the banking system is the transmission mechanism that can take what so far has been a regional crisis global.



## Market Update

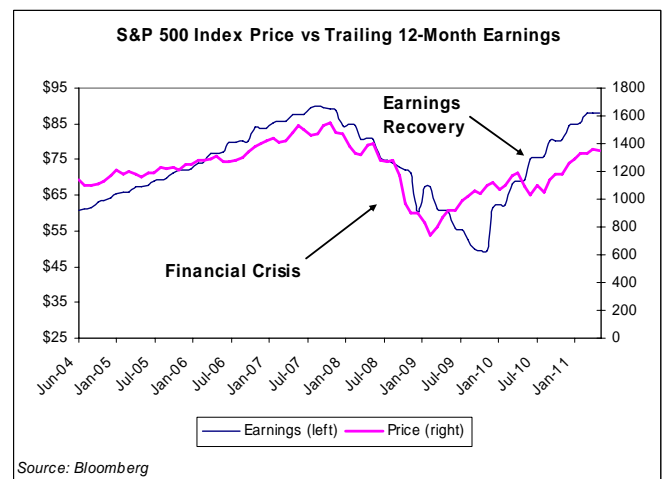
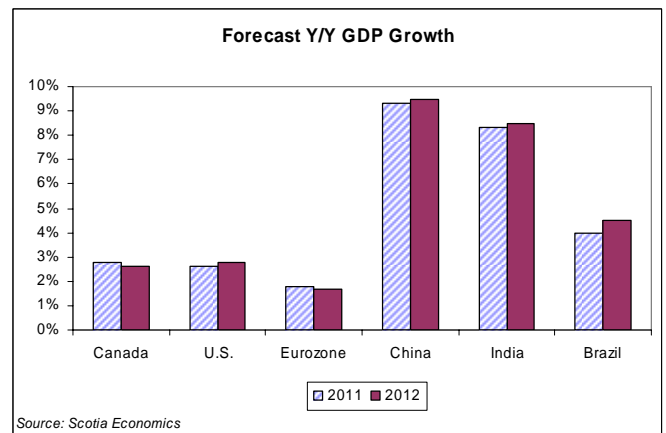
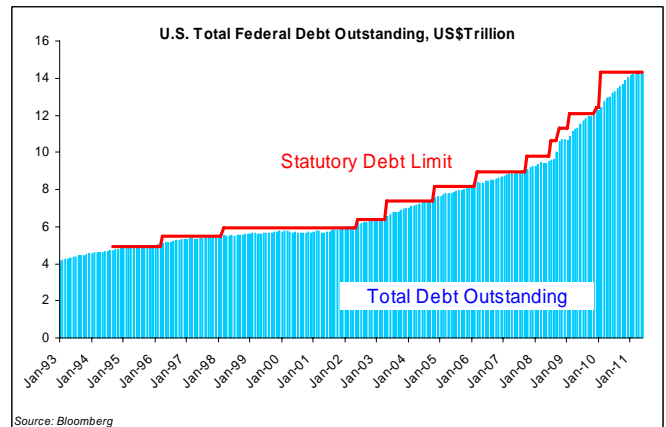
Debt is not just a European problem. The U.S. deficit is forecast to rise to a record U\$1.645 trillion this year and the government has now hit its authorized debt ceiling of U\$14.3 trillion. If the United States chooses not to raise the debt ceiling, the U.S. Treasury can't issue new debt and would eventually default on its debt obligations. That's unlikely to happen, and following a very public battle and political wrangling between the Democrats and Republicans, the debt ceiling will be raised. Thankfully, Canada does not have the public finance problem that the U.S. and peripheral Europe have. Canada is broadly considered a safe place to invest.

### Just a Mid-Cycle Slowdown

Stocks have also stumbled with data suggesting the U.S. and Chinese economies have slowed in the second quarter. The house call suggests this is just a mid-cycle slowdown accounted for partly by the Japanese "disaster" and the higher price of oil. The preconditions for a recession, namely an inverted yield curve, high real interest rates, and excess corporate inventories, are not in place. Nevertheless, the growing debt burden will keep economic growth among G7 nations below trend for sometime. Scotia Economics believes Euro zone GDP growth will stay below 2% this year and next; U.S. and Canadian growth better at about 2.7%. Data suggests Chinese monetary policy aimed at slowing their economy appears to be working, but a hard landing is unlikely given policy flexibility. Overheating in Brazil and India is more problematic, but moderating food and energy prices should help reduce inflationary pressures and the need for "excessive" tightening. Scotia Economics is forecasting global GDP growth of 4.2% in 2011 accelerating to 4.5% in 2012.

### This is not the Beginning of a New Bear Market

Looking beyond the summer swoon, the bull market for equities appears intact. Stocks are the only asset class than seem reasonably priced. Monetary policy remains accommodative with the U.S. Federal Reserve in no position to raise interest rates, and certainly unlikely to tighten meaningfully before the next election. Low rates are forcing many income-seeking investors away from bonds into dividend-paying equities. Given the ongoing slump in U.S. housing and high unemployment, the Fed's only method for affecting consumer wealth and spending appears to be the stock market. Hence, we would not rule out another round of quantitative easing if equity prices continue to slide along with U.S. home prices. Corporate profitability is growing along with the global economy and second quarter earnings season beginning in mid July should help provide support for the equity market. Corporate balance sheets are strong and financing cheap, encouraging productivity enhancing investment and M&A activity, the pace of which is accelerating. M&A premia helps to put a floor price under stocks. Tactical indicators employed by our strategists designed to time shifts in asset allocation, indicate the market may be close to bottoming and investors should be considering increasing their equity exposure.



Advisors and clients are encouraged to review our recommended lists and Guided Portfolios as the basis for their "wish list" of equities. Entry points will be determined by broader market action rather than individual stock quotations.

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