

“Individuals who cannot master their emotions are ill-suited to profit from the investment process.”

- Benjamin Graham



WATSON DI PRIMIO STEEL

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Investment Perspectives

Markets Climb Up the Wall of Worry

In 2010 markets were marked by episodes of depression and mania. The positive about-face began in late August when the U.S. Federal Reserve signaled further easing in monetary policy. Adding to near-zero interest rates, the Fed's second round of quantitative easing ("QE2") — a targeted program to purchase \$600 billion in long-term U.S. Treasury bonds, in an attempt to push down long-term interest rates—removed any possibility that tightening would derail the sluggish U.S. recovery. Since then America's economy has gained some traction showing improved business investment, consumer spending, and job creation.

Building upon a broadening global recovery, the world economy is expected to grow 4.2% in 2011. The International Monetary Fund forecasts emerging economies will grow more than 3 times faster than advanced economies—6.4% compared with 2.2%. Due to this multi-speed growth, we are witness to an unprecedented shift in global output. According to

the Conference Board, the emerging markets' share of global GDP was about 40% in 2000, is 50% today, and will reach about 60% in 2020.

Moderate economic growth and low interest rates are cited as key ingredients to maintain positive momentum in the global economy and, therefore, corporate earnings. The transition from public support to private (business and consumer) demand needs to progress. Business investment—through job creation and capital spending—is expected to make a major contribution to growth in 2011. Even so, this recovery continues to walk a tightrope. The global economy's long-term problems have not vanished. Among the overriding risks for 2011: the sovereign debt problems in Europe, a slumping U.S. housing market, and a potential policy misstep dealing with global imbalances. We are believers in the business cycle, which expands and contracts roughly every four to seven years. 2011 begins the third year of the recovery. *As always, we thank you for your continued confidence and support.*

Equities:

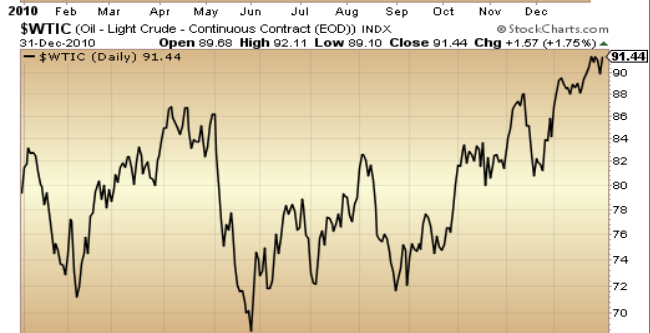
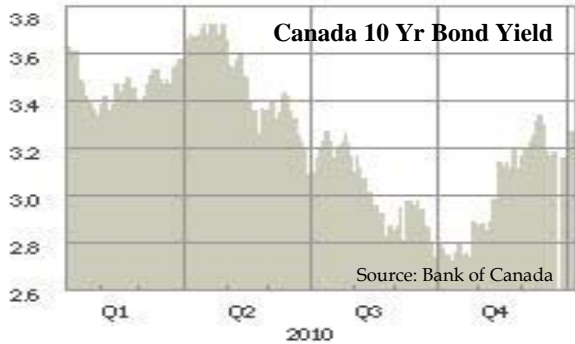
Equity markets remained extremely volatile in 2010, with the outcome based on two different halves (see left-hand charts). At mid-year investors had sold off stocks on renewed recession fears emanating from the European debt crisis. In the second half of 2010 stock prices jumped + 20%, which eliminated year-to-date losses through June. The rapid u-turn surprised many investors.

A synchronized global stock price rally proceeded as America's economy strengthened, and corporate profit margins improved. In 2010 the S&P/TSX Composite price index gained 14.4% (17.6% total return with dividends). In Canadian dollar terms, the S&P

500 gained 9.3% while the MSCI EAFE lagged at only 2.8% in total return. The emerging market stock index ended the year with a C\$ 9.6% gain (price only). Meanwhile, our loonie's rise against other major currencies (US\$ + 5%, € + 11% and £ + 8%) continued to erode foreign market's returns.

In Canada nine of ten sectors advanced. The cyclically sensitive sectors maintained their relative leadership, with the notable exception of information technology. Given improving macro-economic conditions, global demand for industrials, materials, energy, and consumer discretionary goods was rising.





Fixed Income and Interest Rates:

In the third quarter the Bank of Canada raised its target for the overnight rate by 0.50 and then paused, pointing to weaker conditions south of the border. As such, Canada's core inflation was expected to remain subdued, below the Bank's 2% inflation-control target. The key policy rate now stands at 1%. The consensus view is that tightening may resume mid-2011—climbing gradually to 2% by year end. The U.S. Federal funds rate was maintained in the zero to 0.25% band. In concert with QE2 stimulus, there is little chance that the Fed will raise its rate until 2012.

At mid-year the Canada and U.S. government bond markets were pricing in a double-dip recession, with the yield on the 10-year benchmarks at near histori-

cally low levels. But QE2 reinforced the U.S. central bank's resolve to safeguard market participants against adverse economic conditions. So long-term interest rates succumbed and moved higher amid signs of recovery. The US 10-year treasury yield climbed to 3.30%, but remains 0.55% below a year ago. The yield on a Canada 10-year bond, as illustrated to the left, at 3.11% is 0.50% below December 2009.

Government and investment-grade corporate bonds posted gains in 2010. The investment-grade fixed income market returned 6.57%. Corporate bonds continued to outperform government bonds as credit spreads narrowed. With worries of future inflation, the long-term bias for yields is to rise.

Currencies:

Accusations of "currency devaluation" broke out in 2010. This involves countries competing to achieve a low exchange rate for their home currency, thus reducing the price of its exports and helping domestic industry. Given 9.4% U.S. unemployment, a lower exchange rate for the greenback is one means to re-ignite export led growth. Indirectly quantitative easing tends to lead to a fall in the value of the currency.

Canada's dollar is being pressured higher. Our loonie (up 5.4% against the U.S. dollar in 2010) breached parity to close \$1.0054. An elevated value for the loonie, of course, could eventually hurt the Canadian manufacturing sector. Other internal factors that favour the Canadian dollar holding ground against its U.S. counterpart are raising interest rates, high commodity prices, and government deficit reduction.

Commodities:

Commodity prices moved higher in 2010, after rebounding in 2009. Industrial metals like copper and nickel climbed 31.18% and 33.83%, respectively. These gains are attributed to reaccelerating demand growth from resource-intensive global demand. Exchange rates and speculative activity affect these prices too.

In 2010 energy prices rose and fell dramatically as the probability of an economic slowdown in China varied.

The left-hand chart illustrates the final 15.15% rally in the price of oil, which gained US \$12.08 per barrel to reach US \$91.44. Two years ago oil traded at US \$44.

Displayed in the bottom chart, gold surged 29.67% in 2010. Gold closed at US \$1,420.70 and is seen as a multi-purpose hedge against a declining U.S. dollar and both deflation or, conversely, higher inflation in the wake of the unprecedented quantitative easing.

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