SECOND QUARTER COMMENTARY

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THE INDEPENDENT ACCOUNTANTS' INVESTMENT COUNSEL INC.

The Return of the Bears...

After a very strong run in equities during 2009, one could expect some caution in 2010 as stock prices and corporate earnings began the process of alignment. In hindsight, the selloff in 2008 and the first two months of 2009 created excellent buying opportunities for investors seeking value. The increases in stock prices witnessed in 2009 were pricing in economic recovery and increased earnings expectations for 2010. Fear of missing these earnings or revenue forecasts is a part of what has been weighing on stocks in the first half of this year. The other issues are more macroeconomic in nature. As expected, we have hit a few bumps along the way. Global growth, domestic growth in China, European debt levels and the balance between government stimulus and fiscal austerity are all playing a role in generating negative sentiment. However, we need to consider each of the issues in a broader context.

First, relative to historic values and to the risk-free rate of return as measured by the 10-year US treasury yield, many stocks are trading at attractive prices with reasonable dividend yields. As long as the economy continues to grow, stock markets should perform reasonably well over the coming 12 months.

This leads to macroeconomic concerns, which do pose some risks. While the US economy remains a very important part of the global economy, equity returns are increasingly correlated to economic performance outside of North America. Any setback in emerging economies that results in rapid growth falling short of expectations will have a negative drag on North American markets.

Secondly, European debt levels have proven to be a concern worldwide. Investors fearing a contagion effect outside of those centers of concern (or those who fear we will be pushed to the stress levels we experienced in 2008) are fuelling negative sentiment worldwide. The good news is that comparatively, the current European debt issues are of much smaller magnitude than the issues we faced in 2008. This is not to say that we should not be prudent but any fears of a worldwide financial crisis have subsided to some extent.

Finally, we can't ignore the massive amounts of cash that governments around the globe provided to stimulate economic activity and promote struggling sectors. Deficit spending is the basis of Keynesian economics (John Maynard Keynes) and when used in a systematic and disciplined manner, can smooth out economic troughs and peaks, mitigating the impact of recessions. The question that investors are asking is: How much of the economic recovery rests on stimulative spending and is thus at risk when limited programs end? A secondary concern centres on the increase in sovereign debt loads. Although, the world's leaders are divided on policy going forward, the G20 was unified in their response to the economic downturn and the sub-prime issues that came to a head in 2008. Now some, like President Obama, dealing with continued economic headwinds support further stimulus, while others are advocating austerity. Investors are looking for governments to reign in their spending and balance their budgets as soon as possible to ensure the long-term health of the global economy.

Interest Rates will Rise...

Canada's first quarter growth was measured at 6% on an annualized basis. This is an exceptional turnaround and provided the Bank of Canada with the information it needed to begin the process of increasing interest rates. Between low borrowing costs and fiscal stimulus via infrastructure spending, Canada has weathered the global recession in reasonably good shape. With a robust real estate market and the broader economy beginning to create new jobs, the central bank had to start easing into measures designed to curtail rapid expansion, which would eventually lead to inflation. BOC governor Mark Carney has signalled his intentions to slowly increase interest rates rather than apply large one-time increases to shock the economy. Analysts are anticipating continued increases of 25 BPS with the rate settling in somewhere between 1.5% and 2.5% in 2011. The challenge will be to keep aligned with US borrowing costs and keep the Canadian dollar from rising too rapidly. The US economy suffered a deeper and longer recession than we experienced in Canada. Real estate prices rapidly declined from their highs of 2006 and US consumers found themselves overextended. Unemployment topped 10% and the recovery has been slow to take hold. While the economy is heading in the right direction, the US Federal Reserve has indicated that interest rates will remain at current levels, at least for the near term.

Please contact your local IAIC Representative if you have any questions regarding this commentary.

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