THIRD QUARTER COMMENTARY

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THE INDEPENDENT ACCOUNTANTS' INVESTMENT COUNSEL INC.

Stock markets continue to climb...

After stalling and sputtering in the second quarter, stock markets have regained their footing. In fact, September was one of the strongest months on record for the Dow Jones and the TSX. While the media continues to stoke the fears of the weary, hard numbers are easing the likelihood of a double dip recession and investors are responding. While there is no question that economic growth in Q2 was slowing, it remained positive, a significant contrast to what we would be seeing if indeed the economy were slipping back into a recession. Capacity utilization is slowly increasing, consumer expenditures are growing and despite some setbacks, gains are being made in the weekly employment numbers. While there are still some bumps in the road ahead, most economists agree that the threat of a double-dip recession has subsided. As we have discussed previously, stock markets are forward looking and today's price movements reflect investor's future expectations.

One of the largest fears lurking in the minds of investors is the US housing market. Prices have fallen approximately 30% over the past three years with record foreclosures undermining the credit markets. The good news is that the market seems to have reached its bottom and is showing some signs of recovery. The inventory of unsold homes has come off its high, still well off the three or four month supply that is considered healthy, but an improvement over the eleven-month inventory seen just a few months ago. A lagging indicator is the commercial real estate market with New York City serving as a benchmark. Here again, investors are seeing positive signs as vacancy rates appear to have peaked and occupancy is on the rise.

Another issue galvanizing negative sentiment is the Japanese experience of the nineties. Known as the lost decade, Japan has still not recovered from the severe downturn it faced nearly twenty years ago and there is some fear that the US economy may be going down the same path. Three major differences however, are leading analysts to minimize the weighting they put on this scenario. First, in response to crisis, the US reacted quickly and decisively, lowering interest rates immediately to stimulate the economy whereas this was a long and drawn out process in Japan. Secondly, the US reacted quickly to recapitalize the banking system with the TARP program. It took Japan nearly ten years to recapitalize and for Japanese banks to start lending after the NIKKEI was set back. Finally, Japanese stock valuations were extremely high with the NIKKEI index priced at 100 times earnings in 1989. Contrast this to US stocks, which have always been reasonably priced and today, offer relatively good value in contrast to fixed income. One final point worth considering is that shifting demographics were a drain on the Japanese domestic economy but are expected to provide a "tailwind" to the US economy over the coming years.

In summary, we tend to align our position with analysts who feel the probability of a double dip-recession has subsided and that the US economy will continue to recover, avoiding a lost decade that some fear. In fact, more moderated growth will be good for the economy, keeping inflation in check while fuelling the growth of corporate profits. Stock valuations continue to offer investors a significant premium for the added risk they incorporate.

Gold and the US Dollar...

A general rule of thumb tells us that when cab drivers start to speak of a specific investment opportunity, the train has already left the station. When everyone is talking about real estate, tech stocks or commodities, it is often an indicator that we are entering what is commonly referred to as a bubble. Throughout 2010, we have observed a renewed interest in gold and other precious metals. To those who have seen an economic cycle or two, this is déjà vu. Jumping into gold with big bets at $1,350/ounce is risky speculation. We have seen gold double in price over the past three years, responding to the economic woes facing the US economy. We do not want to diminish the value of gold in a portfolio. It tends to be negatively correlated with the US dollar and the US economy acting as a natural hedge against stock market declines. We also favour holding gold producers in a stock portfolio vs. holding the actual physical commodity. Owning stocks such as Barrick Gold or Goldcorp provide benefits of leveraged exposure as well as dividend income. If investors continue to turn their backs on the US dollar, gold will continue to appreciate. Our belief though is that the US economy will continue to recover, which should provide stimulus to the US dollar over the next 12 – 24 months.

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

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