

FIRST QUARTER COMMENTARY

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THE INDEPENDENT ACCOUNTANTS' INVESTMENT COUNSEL INC.

Political Instability and a Tsunami...

As forecasting goes, economists and financial analysts have done a good job of prognosticating the economic recovery and the market's response to an improving outlook. This year, most industry professionals agree the US economy should continue to recover, but stock markets will generate smaller gains than those of 2009 and 2010. However, there are always unforeseen events that impact the markets; the first quarter of 2011 was no exception. Political upheaval in the Middle East and a devastating earthquake in Japan have both been significant events that have impacted financial markets and may continue to do so throughout the remainder of this year.

The recent events in the Middle East have not only resulted in democratic reforms in countries such as Tunisia and Egypt, they have introduced additional risks to global equity markets. While the world may celebrate the shift of power from dictatorships to the people, the financial markets have a different perspective. A dictator may be cruel and oppressive, but they often instil political stability and align a resource rich nation with western interests. The ongoing struggles in Libya have had an impact on the world supply of oil, driving up prices to well over \$100 / barrel; although, some analysts discount the impact of the unrest and attribute much of the current volatility to speculation. A commonly held long-term concern is a newly elected government may be ideological and fundamentalist in nature and at odds with capitalism. Further disruption to the world supply of oil will result in sustained pressure on

prices and be a drag on both industrialized and emerging economies.

Natural disasters can precipitate economic shocks the markets are able to recover from quickly. However, the earthquake and tsunami in Japan had both natural and man-made elements in its totality. As devastating as the destruction and the loss of life has been, the silver lining in this very dark cloud is the economic stimulus the rebuilding will provide in the years to come. The bigger economic risk lies in the damage to the nuclear facilities. Worldwide there are over 500 nuclear reactors on line and even more being constructed. Previous nuclear accidents have been rationalized, but the Japanese facilities were built to the highest standards. As engineers struggle with containing radiation leaks, the question turns to a potential shift in attitudes and the willingness to build new nuclear reactors. A push back would have an obvious impact on industries directly tied to nuclear development but more importantly, could impact the current and future supply of clean electricity in both modern and emerging economies.

The Surging Canadian Dollar and Interest Rates...

Those travelling to the US are enjoying the benefit of a strong Canadian dollar. However, as a net exporter, a strong dollar hurts the Canadian economy as a whole. Our manufacturing sector is heavily dependent on exports to the US. The recent surge in the CDN/US exchange rate is making Canadian goods less competitive in foreign markets. This has been an ongoing challenge for the Bank of Canada. On a comparative basis to other G8 nations, the Canadian

economy has done extremely well with housing remaining particularly strong. Inflationary pressures associated with a strong economy are starting to factor into the Central Bank's strategy despite the fact we are not running at full capacity. In an effort to avoid adding the burden of higher interest costs to manufacturers and retailers facing the challenges of a strong dollar, the Central Bank has not increased interest rates recently. However, as the Canadian dollar settles and possibly pulls back, the Bank of Canada is likely to resume increasing its key overnight lending rate to curb inflation. The US Federal Reserve is less likely to increase rates in the near future as the American economy is still struggling to find its footing. For Canadian investors, positioning the fixed income portion of their portfolios to mitigate the impact of rising interest rates remains a prudent strategy.

The Price of Gold

With gold nearing record highs of \$1,500 per ounce and prominently in the news, we are often asked about holding gold in our clients' portfolios. While we do not hold gold bullion or bullion certificates, we do invest in gold producers. This provides our clients with an indirect investment in gold, highly correlated to the price of bullion. Regardless of its price, maintaining some gold exposure in a portfolio is a proven risk mitigation strategy, leveraging the historical negative correlation between the US dollar and gold prices. However, like any single investment, IAIC limits exposure to manage volatility and risk in portfolios.

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