2011 Year End Report

2011 Economic and Market Review

January 2012

Volatility was the rule in 2011 as the stock indexes went from a gain of about 5% in March to a loss of 15% by October, a 20% swing, before a rally ensued to end the year resulting in the global markets reducing the loss for the year to a little less than 9% . This volatility began with the natural disaster in Japan, which was then followed by the ongoing Sovereign Debt soap opera in Europe, and the U.S. debt-ceiling debate and credit rating cut in late summer. These issues have caused investor sentiment to drop to very low levels, and individuals and companies to hoard cash. As a consequence, stock prices are trading at a significant discount to historical average valuations.

The TSX was the most volatile during the year having endured a swing of 23% from the March peak to the October trough. Surprisingly, the U.S. market was flat for the year in Canadian dollar terms, as economic indicators there began firming up in the last quarter. The improvement in the U.S. economy in the final quarter runs counter to 'experts' who were calling for a 'double-dip' recession last summer. It appears as though final GDP numbers for the U.S. and Canada will be in the 2% range. This is considered slow to moderate growth, but it is growth nonetheless and therefore a positive.

Some economic observers believe that weakness in the European economy will derail the nascent U.S. recovery. However, when looking at trade data, we find that Europe represents just 20% of U.S. exports. If the European economy were to contract 5% due to a recession it would merely knock-off a small fraction of U.S. GDP. More critical to the U.S. economy is the domestic housing market. Insights from a prominent U.S. portfolio manager indicate that there are plenty of jobs in the U.S. but they require higher education in engineering and technology. The vast majority of the 8.5% unemployed are unskilled workers who traditionally find work in the housing sector.

The housing market in the U.S. has hit rock-bottom and is therefore, unlikely to contribute to further weakness in the economy. In fact, recent economic data is pointing to a modest improvement in the housing picture. Therefore, in the future, the housing market can only help and not hurt, U.S. economic activity.

2012 Outlook

There was a key development in the European debt saga in December. The European Central Bank (ECB) purchased Italian bonds on the open market to help Italy deal with some maturing bonds. This act is significant, in that, being the 'lender of last resort' is not part of the ECB's mandate. The ECB's primary mandate is to control inflation. This event is a 'game changer' for the European debt problems. Italy and many other countries have a significant amount of bonds coming due in the first quarter of this year. If the ECB steps into the open market again and buys more bonds, they will have effectively contained the debt problems and have bought all member countries the time to re-structure their finances. With the potential of this issue dropping off from the news headlines, global investor sentiment may finally start to move the stock markets higher; we'll know better by April.

The next big news this year will be the upcoming U.S. Presidential election in November. Given the political process in the U.S. with endless primaries to select the Republican candidate, it is likely that this will now begin to dominate the media. U.S. congress has been in a stalemate ever since the Republicans took control of the house in 2010. Democrats and Obama want to spend more money and raise taxes, while Republicans are pointing to the record government debt and budget deficits and are saying 'no more'.

Obama came into office with much promise and hope for a change in economic direction. Under his watch, deficit spending accelerated rapidly and the economy showed only modest improvement. A large number of Americans are unhappy with President Obama and it appears likely that there will be a change of resident in the White House this November. The question is - will a Republican President make the tough choices required to repair America's balance sheet, or will he perpetuate the easy decisions of the past. The American government is on an unsustainable fiscal path that, if not corrected, could lead them to a debt crisis to match the worst in Europe in the next decade.

In summary, 2012 has some great potential and stocks are clearly undervalued, but political uncertainty may make the ride rocky again. With the right conditions unfolding, markets could end the year much higher than they began.

Investment Strategies for 2012

Clearly with the volatility of the last 5 years, some investors are experiencing market 'fatigue'. However, it is more important to focus on your goals and objectives than daily market reports. You can control how much you save or withdraw from your portfolio, but you cannot control the movements of the financial markets. Retirement funding is a major issue in Canada as the majority of Canadians don't have nearly enough saved to replace even half of their pre-retirement income. As a general guide, investors should be saving 20% of take-home pay for retirement, and withdrawing no more than 4% of their portfolio value annually for income.

We have assembled some conservative investment options for those experiencing 'market fatigue', utilizing short-term and corporate bonds. However, long-term expected returns in these categories are lower than what is expected in the future for portfolios containing some portion of equities. As a result, savings rates would have to be increased to offset the reduced potential returns from conservative investment options.

Counsel strategic portfolios performed in line with their asset allocations in 2011. Since most of our clients are invested in 'balanced portfolios' with a 60/40 asset mix, their average market decline was in the low single digits versus minus 9% for the broad stock market indexes.

We have some creative solutions whether you are looking for growth or income, so please contact us if you have any questions or would like to learn more. Remember, we continue to have access to a wide range of investment products, including those offered by most Canadian banks. The asset mix of any portfolio is actually more critical to performance than which company offers the product.

The RRSP deadline is February 29th, 2012 this year, so please make sure you either mail in a cheque or drop by the office with your 2011 contribution. All cheques should be made payable to 'IPC Investment Corp. in Trust'.

Have a great year.

John Soutsos