

Financial Focus

Monthly Opinion by Cesar Lauper, CFP, AMP, Manager, Sipan Capital Inc.
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The Year Past, The Year Ahead, A Gift from the Capital Markets

Every time I think about the future of investing, I attempt to think about the lessons learned from the past, and although past performance is certainly no indication of future returns, history can be a good foundation from which to draw opinions for interesting debate. The past behavior of the markets has in part been driven by the human characteristics of greed and fear, more greed than fear I would argue, hence the boom bust and echo tendencies of the markets. Fundamentally, our democratic capitalist system can only continue its success and survival by the sustainability of the consumerism philosophy which is partly driven by the constant depreciating purchasing power stored in our currencies, thereby encouraging ongoing spending or investment in the capital markets. This year, and perhaps the years ahead, we should heed the guidance of the massive search for yield from investors in the developed economies. The asset classes that show relative good risk/return characteristics should perform well, preserving capital and most importantly preserving purchasing power. The mature investor from the developed economies of the world want yield for income requirements and prefer it for fear of the volatility of riskier asset classes. Yield demand is driving capital flows to dividend payers and emerging market debt, which combined with the effects of quantitative easing could fuel the birth of a new financial bubble. The historical relationship between risk and reward is being inverted in the long term; to be invested could prove to be less risky than not being invested at all if inflationary fears prove to be well founded. The past twelve months have been about finding true value, about making sense of the debt levels incurred by the developed nations and about finding opportunity in the developing world. The next twelve months may be about building upon the footings set in the emerging economies, seeking yield in emerging economies.

Emerging sovereign debt, where property rights are the root of economic development, offer cautious short term prospects, finding opportunity in a long term shift of currency supremacy, the explosion in population growth, a continued reduction of poverty lead by the growth of capitalism as globalization continues its course, increased consumer demand from developing economies and the unwavering determination from a learned leadership concerned more with the significant economic problems which can be caused by deflation than the longer term threat of uncontrolled inflation.

Inflation should be kept in check at least in the near term. Although the quantitative easing measures taken have been impressive and the printing or production of electronic dollars has increased; inflation only occurs when you have too many dollars chasing too few goods, for the time being the dollars that have been injected in the economy have been stuck in the system and the multiplier effect of capital has not taken hold. Banks are simply not enticed to increase money velocity or lending since they are being compensated to maintain capital in their reserve accounts. I would expect this to begin changing as the conditions of Basel III are implemented, increased M&A activity and simply overall increased lending could in effect put further pressure on inflation expectations, even on the backdrop of an offer of 100% certainty of inflationary controls by Fed Chairman Bernanke. The impetus of the economic stimulus is challenged by the increasing duration of unemployment and lack-luster job creation. Real wages are likely to decline in an employer's market that expects long term recovery challenges. As a result consumer demand although expected to improve should not be expected to increase to above historical levels, implying a long road to the recovery of the ideal unemployment levels enjoyed prior to the downturn, even considering pent up demand for durable goods. Sustained growth can only be achieved by private final demand which should be challenged by a steady elevated unemployment rate, low house prices and a somewhat limited ability to refinance (forcing some to apply strategic mortgage default, which has been on the rise) and the downward pressure on house prices by the housing overhang in foreclosures and vacant houses which remain a significant factor in house price stability. This downward pressure is expected to be somewhat balanced by the continued solid economic expansion of emerging market trading partners that are contributing measurably to export demand.

The Fed and other central banks have been working towards a sustainable rate of inflation, with a target of slightly above zero, namely between 1 and 3 percent. Their credibility would be tarnished should inflation prove to be a significant concern, which would perhaps increase the expectation of inflation; this increased expectation could start a vicious circle of price increases by manufacturers and consumers. As manufacturers expect prices to increase they would demand higher prices for their products and consumers expecting higher prices in the future would demand more goods in exchange of a declining currency. My personal bias is that inflation will be subdued for some time and only time will judge Mr. Bernanke's 100% assurance of inflationary control.

Currency debasing continues on course amongst many countries, this competitive protectionist measure should provide the backdrop for future economic developments including the concern of the survival of the not as mighty Euro, a declining American dollar and the rising of Asian and certain Latin American currencies. In fact, in a recent public appearance, Mr. Craig Alexander, Chief Economist for TD eluded to a the Euro reaching parity with the U.S dollar. Capital flows to resource rich economies such as Canada and Brazil will be interesting to follow as their protectionist actions attempt to moderate the uncompetitive and potentially deflationary results of their appreciating currencies. Historically money follows returns and runs from depreciation, so capital should be looking at dividend payers and higher yielding income assets. Should inflation start to take hold; although improbable; hard assets will be much sought after, some have already begun on this course.

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A document from Dominion Bond Rating Service has indicated that Basel III's new capitalization requirements should have no impact on Canada's five largest banks, since they have been identified as systemically important to Canada their rating for long and short term issues has improved, however should these banks be identified as Global Systemically Important Banking Institutions, they could be negatively impacted since their capitalization requirements would be higher. In either event, however, Canadian Banks should benefit from capital seeking income.

Global GDP continues to grow within lower bound historical range assisted by the growth of emerging and resource based economies and the revitalization of the U.S through continued stimulus spending. The U.S. consumer is showing signs of resilience, consumers from developing nations continues to grow. These are all positive for equity markets over the foreseeable future.

Interest rates in the U.S are expected to remain unchanged for the better part of 2011 and perhaps extending their record low level into 2012, continuing its support for the growth of the economy. The impact of the stimulus, combined with a depreciating currency and low interest rates may positively surprise estimates of growth from a low of 2% to 3.5% or even 4% in 2011. I continue to be bullish on U.S. equities particularly in the small and mid-capitalization issues as all factors combined with the need to deploy capital increase takeover targets.

Interest in Canada are expected to rise to 2% from their current 1% level, perhaps subduing growth but not significantly. Canada is estimated to grow at 2.5%. Canada is still a good place to be.

Emerging economies are the force to be followed with China expected to grow at 9.5%, most Asian and Latin American economies expected to continue growing at a combined rate of 6% compared to 2% of the developed world.

In a general letter to investors, Bill Gross, of PIMCO declared his intentions to focus his efforts in the placement of a increasing amount of holdings in Emerging Market Sovereign Debt where he may find better yield and benefit from increasing currency valuations. In his November letter entitled "Run Turkey, Run" he stated "Check writing in the trillions is not a bondholder's friend; it is in fact inflationary, and, if truth be told, somewhat of a Ponzi scheme". To get reasonable returns, he continued, "Interest rates may be rock bottom, but there are other ways – what we call "safe spread" ways –to beat the axe without taking a lot of risk: developing/emerging market debt with higher yields and non-dollar denominations is one way; high quality global corporate bonds are another ." In my opinion, his statement hold reasonably true to Canadian Bonds, favouring to a degree emerging market debt with a continued cautious approach.

With all of the above in place, and expecting a short term correction, hard and soft commodities should continue their growth pattern for some years into the future.

Economic Indicators:

At the annual Economic Club of Canada economic outlook meeting held in Toronto on January 6th, Mr. Marzolini, Chairman of Pollara, Canada's leading public opinion and market research firm stated that the difference between pollsters and economists is that pollsters have been successful at predicting 2 of the last three recessions while economists have predicted 5 of the last three recessions. For what it's worth, looking ahead has proven more successful than looking back to make decisions about our future.

Looking at various indicators:

Population growth Canada: 0.8% - constant

Unemployment rate Canada: 7.6% nov. 2010 - improving

Unemployment rate U.S.: 9.6% nov. 2010 - improving

Canada Bond rate: 10 year 3.16% December 2010 - lower

U.S. Treasury rate: 10 years 3.5% December 2010 - lower

U.S. ISM index of manufacturing : trend growing faster for 17 months

TED Spread: below 20 basis points for over 12 months

Baltic Dry Index: trending lower on a 50 day average

VIX: 11.56 December 2010 - low range

Consumer Sentiment: 74.5 December 2010 - trending higher for 12 months

With most indicators improving and trending higher, other than short term corrections, growth expectations seem to be well founded.

Economists Predictions:

At the Economic Club of Canada 2011 outlook breakfast with Warren Jestin of Scotia Capital, Sherry Cooper from BMO Capital Markets, Craig Wright at RBC Financial Group, Avery Shenfeld of CIBC World Markets, and Craig Alexander at TD Bank Financial Group, these renowned economists predicted the following:

Warren Jestin, GDP 2.2%, interest rate 2%

Sherry Cooper, GDP 2.75% interest rate 2%

Craig Wright, GDP 3.2%, interest rate 2%

Avery Shenfeld, GDP 2.2%, interest rate 2%

Craig Alexander: GDP 2.6% interest rate 2%

Clearly a consensus for growth

Sipan Capital Inc

Security, Independence, Prosperity, Advice, Now

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Words of Wisdom

"Psychology is probably the most important factor in the market – and one that is least understood."

David Dreman

Dreman Value Management, L.L.C.

" Most of the time stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble ... to give way to hope, fear and greed."

Benjamin Graham (1894-1976)

Graham-Newman Corporation

"Investing without research is like playing stud poker and never looking at the cards."

Peter Lynch

Fidelity Magellan Fund - 1977-1990

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