March Market Comments

General Comments

"2012 appears as though someone walked in, turned on the lights, and declared the United States open for business", according to research Analyst Neal Soss with Morningstar. US stock indexes have now pushed higher than peaks reached in April of last year, while the Canadian index is still 11% below its peak nine months ago.

US ISM New Orders is one of the best leading indicators of economic activity. The indicator has remained in an "expansionary" zone above 50 since late 2009. Through mid-2011, this measure began to precipitously drop and seemed to be heading for potentially recessionary levels. But since last October, the indicator has firmly bounced and has moved on to suggest healthy expansion.

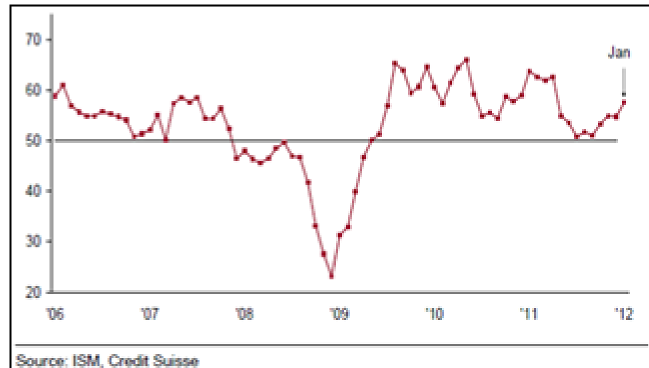
The most recent estimate of annualized U.S. Q4 GDP growth was 3.0%, increasing from the 2.8% prior estimate. Consumer spending growth was revised to 2.1%, up modestly from the 2.0% advance estimate and reflecting stronger spending on services. Unemployment levels in the U.S. have fallen from a peak of 10.0% in October of 2009 to 8.3% now. Housing starts peaked in 2006 in the U.S. at more than 2 million new homes per month. The subsequent economic crisis drove starts down by nearly 80%, to below 500,000 per month by 2008. Over the last three years, housing starts have crept steadily upward to closer to 600,000 per month – a long way from prior peaks, but starting to show modest and consistent growth.

The Federal Reserve indicated that low interest rates will likely be needed until late 2014 in order for its mandate of price stability and full employment to be achieved. This means almost three years of significant stimulation to the economy.

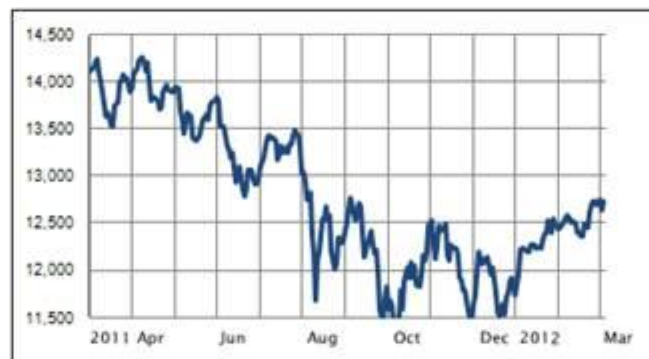
Since economic activity started to appear stronger late last year, money has been flowing out of defensive sectors (utilities, telecom, health, consumer staples), and into flow to sectors associated with a trough or early recovery in the business cycle. Financial stocks in Canada and the U.S. are showing outperformance compared to the market average for the last three months, with the Canadian banks recently reporting earnings that handily beat analyst estimates for nearly every bank. Consumer discretionary and information technology sectors in the U.S. are showing very strong outperformance. Industry sectors that typically perform well later in the business cycle such as metals and industrials are generally not receiving money flows yet, confirming that the recovery, if indeed it has started, is only in its infancy.

Market Snapshot

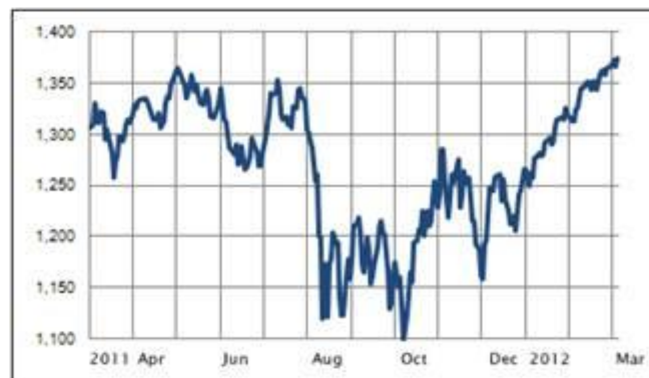
US ISM New Orders



S&P/TSX COMPOSITE



S&P 500 INDEX (US)



Current Strategy

In the short-term, selling stocks and building cash and defensive positions in both stocks and bonds seems prudent. The rebound in the economy should not be ignored, and may be a sign that greater economic recovery is coming quicker than investors realize. This optimism has to be tempered with the likelihood of an overall slower pace of global economic growth. Restructuring of Europe, new attitudes promoting deleveraging of debt, and excess unused manufacturing capacity may limit the rate and magnitude of growth in the next cycle.

The U.S. has significantly outperformed Canada since early last summer. South Korea, Malaysia, Singapore and Brazil also come up as early outperformers in the latest rally. Adding positions in these global markets may take place in managed accounts over the next few months.

Despite the economy and stock markets showing multiple pieces of evidence that they have bottomed, individual stock prices are firmly in significantly overpriced territory. Many cyclical and basic consumer stocks have run up quickly over the last few months and have too much risk of a typical price pull-back to buy at current lofty levels. The opportunity seems instead to be reducing stock positions and writing covered calls. Some of the more defensive positions like BCE traded lower in the midst of the strong rally since October, and are at much more attractive acquisition price levels.

Managed Accounts – February Transactions

Managed accounts are discretionary accounts in which I can proactively make trades in a client's best interest based on a written Investment Policy Statement and an intimate understanding of their financial goals. Conflicts of interest from commission are eliminated since all trades are free. Logistical difficulties in contacting clients and obtaining authority for changes they would likely want are eliminated and all parties gain time not spent on discussing small details of individual securities. Instead, time can be focused on wealth planning and discussing what the client feels is important and wants to discuss.

The comments below represent changes I have already made for managed clients, but also represent a good source of ideas for those that manage their own portfolio and rely on me for implementation, ideas and a source of professional feedback.

Summary: *Managed accounts increased exposure in defensive sectors that have weakened since the powerful rally that started a few months ago. Cyclical and economically sensitive sectors seem to be closer to selling prices and one such position was trimmed, while prices of some defensive sector companies have dropped back to a reasonable acquisition point. Portfolios remain postured more towards defense. Although some confirmation of a market trough has occurred, the sharp upward moves for many individual stocks makes it a dangerous point to be significantly adding to equity. But should market indexes weaken, it is more likely a buying opportunity in the early stages of an economic recovery.*

Existing Positions Added To:

BCE Inc: On revenue of $19.7 billion in 2011, BCE has free cash flow of $2.7 billion, and pays shareholders a dividend of 5.3%. The stock peaked around Christmas at $43 per share, but dipped just under $40 in February. It is facing greater competitive pressures in serving data-hungry smartphone subscribers, which unfortunately makes overall growth fairly slow. I consider it a core defensive holding at this time in portfolios and the recent price dip allowed me to increase exposure.

Claymore Gold Bullion ETF: This exchange traded fund's price moves in the same proportion as gold, but has its value hedged to the Canadian dollar. It could be the late stages of the bull market for gold, and gold itself is becoming more of a trading position than a trending position. A strategy is now being implemented to write covered calls on positions on this ETF, to move it from a growth position that hedges currency problems in portfolios to a security that produces ongoing income.

Neo Material Technologies 5% 12/31/17: The stock of this company is extremely attractive. Rare earth production companies are uncommon, and this one is highly profitable with nearly no debt and a fantastic growth rate. Their JAMR facility west of Shanghai was approved by Chinese inspectors recently for continued production, and the ZAMR facility, south-east of Beijing has received a preliminary production quota allocation, and is waiting for final inspection approval. The stock currently trades at an inexpensive 6x forward consensus earnings estimates with virtually no debt. Owning the convertible (trading around 97-98 cents on the dollar), is a way to get nearly a 6% yield for the next five years, with the opportunity to grow with the stock if it moves upward enough. It is a more conservative way to gain income with less risk but still have eventual exposure to stock appreciation.

TEVA Pharmaceutical Industries: Teva is one of the largest generic drug manufacturers in the world. They also have some proprietary drugs they have developed and manufacture for multiple sclerosis, bipolar depression, asthma, and cell therapy for heart failure. With a revenue base of close to $20 billion, they have free cash flow of approximately $4.1 billion and trade at an inexpensive 8x times forward earnings. The stock peaked at U$66 in February of 2010, and despite continued earnings growth (although at a slower pace) since then, the stock hit a low of U$36 in October. Subsequently, it has rallied to U$45 per share but still has substantial growth potential given the company's earnings, and the large number of U.S. drug patents set to expire in 2013, which they will likely start producing generics for.

Valeant Pharmaceuticals Intl: This company has greatly diversified its product line with more than 400 products, none making up more than 10% of revenue. It has exposure to Canada, Australia, Central Europe, Latin America and the United States. The company's core strategy has been to acquire small product lines that stay away from competing with the large pharmaceutical companies. One significant area the company makes products in relates to dermatology, particularly creams, and they do have a promising proprietary epilepsy drug which could be extremely profitable. Credit Suisse First Boston estimates a 27% average five-year forward compound earnings growth rate for the acquisition-oriented company. Subsequent to month end, the stock jumped significantly and covered calls have now been put in place to gain income and set a target selling price.

Reduced Positions:

Canadian Energy Services & Technology: Last month's market comments discuss the increase of exposure to this stock, bought close to the $10 range. It's time to take profit already on some of the position, since it has jumped closer to $13. It has traded between $10 and $13 for a year now, and although it remains in the portfolio, I will likely continue adding to the position when it falls closer to $10 and reducing it as it closes on $13.

Covered Calls Written:

Ishares MSCI Brazil Index Jun $76
The Gap Jun $25
Rogers Communications Mar $40

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