



# Caldwell Investment Management Ltd.

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## INVESTMENT REVIEW AND FORECAST APRIL 2011

# HOPE IN AN UNCERTAIN WORLD

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When our January Forecast was published, the biggest issues in the headlines were the riots in Greece over raising the mandatory retirement age and the Duchess of Cornwall being assaulted in her Rolls Royce over rising tuition costs in the U.K. It all seems like an age of innocence by comparison to the present concerns in the Middle East and Japan.

### **JAPAN**

Much has been written from an economic, scientific and above all, personal perspective about the tragic earthquake and the tsunami that followed. It is worth writing something about hope and there is hope possible from all the wreckage along Japan's east coast.

But first a bit of history. Japan has been in an economic and cultural malaise for more than twenty years. The only country in the world not subject to massive civil war or epidemic to have a shrinking population, Japan has chosen to adopt a one child policy as its cultural norm. In contrast, this is a "choice" that could only be forced on Chinese couples by the coercive power of the largest totalitarian state in history.

This behaviour is symptomatic of a Japanese culture that has lost the will to attempt anything new or great. It was the force of will and a people unified in its determination that lifted Japan out of the Middle Ages during the 19th century to become a global

power by the early 20th. In the aftermath of the Second World War, the same national pride that led Japan to take on the United States militarily enabled the country to rebuild and again challenge for global supremacy, but this time economically. Yet all this seems to have ended with the collapse of the Japanese market at the end of the 1980s and the technical insolvency of its banks, which still has not been set right.

This failure to put its own house in order deprived Japan of the growth that the U.S. and Europe experienced in the 90s. Neither did Japan participate with its neighbouring countries during the Asian surge throughout the 00s. Japan's stagnation, as much as China's growth, has allowed the world's most populous country to also become its second largest economy.

While economically moribund, Japan has amassed one of the largest debt to GDP ratios in the developed world and this has left it ill prepared to cope with the present crisis. Some have written that the economic impact of the combined forces of earthquake, tsunami and nuclear fallout could finish Japan, but this may not prove to be the case. It can take a crisis to make a person or a people who have been purposeless come to their senses.

The hope for Japan as a nation is that it is able to unite to rebuild itself. In the short-term, one could say that this rebuilding should increase demand for steel,

timber and other basic commodities. One could even buy uranium miners like Cameco (“CCO”) on the reasonable belief that fears about nuclear power are overblown. As an important trading partner, as a democratic counterbalance to the growing might of China and as a refiner of new technologies, it is in the long-term best interests of the global community to have Japan re-emerge as a dynamic economic force.

## **MIDDLE EAST**

Hope is in evidence in the Middle East also, but so is violence and civil war. The “Arab Spring” which began in Tunisia as one man’s protest against police corruption has now spread to Egypt, Yemen, Syria, Bahrain and, mostly violently, to Libya. Political change is imminent, or has at least been promised, in several of these nations, but foreign powers have, as yet, intervened in just two, Bahrain and Libya, and for very different reasons.

The Kingdom of Saudi Arabia, in its view, cannot allow the Shiite Muslim majority in Bahrain to take power away from the ruling family, who, like the Saudi royals, is of the Sunni Muslim sect. Perhaps more importantly, the toppling of a royal family in the Arabian Peninsula by its own people would set a very bad precedent for the House of Saud.

Indeed, the precedents being set in the Middle East are worth observing by more than just neighbouring potentates. This has been called “The Facebook Revolution” in reference to the use of the social networking site, along with Twitter, to coordinate protest activities nationally and transnationally. Fear of how far this technology can go and the ideas it is being used to spread has caused China to aggressively clamp down on any media outlet or website that reports on the uprisings.

In keeping with Western culture generally, the uses to which our society has put these technologies has ranged from the pleasant to the purient, but so-called developing countries are showing us that very much more is possible.

On the subject of the West, the rationale for intervention in Libya by the NATO powers, including the United States, United Kingdom and Canada, is not well understood at all. Colonel Muammar Mohammed al-Gaddafi, Libya’s dictator since 1969,

was, in his time, the largest sponsor of anti-western terrorism in the world. Yet in 2004, in the wake of the Iraq invasion by the U.S. and the U.K., Gaddafi repented of his extra-national adventures, met U.K. Prime Minister Tony Blair and settled down to a life contented with persecuting his own people. While not a Western ally, as such, relations with the West had warmed considerably which makes the present obsession with toppling his regime more puzzling, especially in contrast to Iran.

In 2009, U.S. President Barack Obama said not one word to encourage the peaceful demonstrations against the corrupt “elections” in Iran, America’s most dangerous and belligerent antagonist. Clearly the time is right for change in the Middle East and even modest U.S. support might have started a “Persian Spring” two years ago. Instead, the Iranian demonstrations were brutally crushed and the reprisal executions in that country continue. In light of this passivity against a genuine threat, why has the same U.S. President ordered attacks on Libya to aid an armed uprising led by we-don’t-know-who?

Moreover, it appears that resolving the violence in Libya may prove to be a task equal to that of Iraq or Afghanistan. One implication of this uncertainty is that energy prices will likely remain higher than they would otherwise. We are continuing to build positions in energy stocks that do not have significant Middle East exposure. In this sector, Canada has some marvellous advantages. Canada is the most stable major energy exporter in the world. Its public stock market has major integrated producers like Suncor (“SU”), Canadian Natural Resources (“CNQ”) and Cenovus Energy (“CVE”), the former oil division of Encana. Oil services companies like Trican Well Service (“TCW”) and Canyon Services Group (“FRC”) perhaps provide the best leverage to growth in North American energy exploration.

## **AMERICA**

The revolutions in the U.S. itself are of a more prosaic nature. There are “Tea Parties” and attempts by state governors (notably Wisconsin and Ohio) to overthrow the power of the civil service unions. The public sector is the only area of the North American economy in which union groups still hold significant power. Private sector unions have largely seen their

host companies go bankrupt (e.g. auto manufacturers, airlines) or move production overseas (e.g. all other manufacturing, data processing, call centres). These measures may be too late to avert the insolvencies of state and local governments across America, however. In 2008, we witnessed a collapse in the corporate bond market; 2011 or 2012 could well see a collapse in the market for “muni” bonds, which are a major component of \$2.9 trillion investment and savings portfolios in the U.S.

America is an interesting case as a comparison to Japan. The U.S.’s great strength is its ability to adapt – even to admit that “mistakes were made” – in order to clean them up and move on. In 1989, as Japan was beginning to refuse to properly deal with its banking insolvencies, the Savings & Loan crisis hit the U.S. Not without the taint of self-dealing, the creation of Resolution Trust allowed America to get past the crisis and enabled the tremendous technology driven boom of the 90s to unfold. The U.S. has gone on to have two financial collapses since then: The “Tech Wreck” / corporate scandals of the early 00s and the financial collapse of 2008. This “boom and bust followed by a greater boom” cycle appears to be part of America’s economic DNA. The country has repeatedly proven capable of growing its way out of these crises and it seems reasonable that it can do so again. Stock markets for the past two years have anticipated this growth and we believe that an ongoing economic expansion will have a profound effect on moving interest rates upwards.

## **BONDS AND RISING YIELDS**

Very simply, bond yields should be considerably higher than where they are at present, but for the combined shock of the European riots, Arab uprisings and Japanese disasters. The underlying strength of the North American economy and the need for governments at all levels to borrow even greater sums will, at some point, require the price of money (i.e. interest rates) to rise.

The only real weakness in the U.S. economy is the housing market. This sector will continue to be weak for 5-10 years, possibly longer. Housing cycles are long, but the rest of the economy works around them. U.S. corporations hold record amounts of cash. The five largest technology companies alone have over

\$150 billion in cash between them available to make acquisitions. To take advantage of this possibility, we have added significant technology manufacturers like Broadcom Corp (“BRCM”) and Cirrus Logic (“CRUS”), which are potential takeover candidates.

## **CANADA**

The Canadian economy is even stronger than the U.S. All of the three largest market sectors (financial services, mining and energy) have been extremely profitable. Of these, the energy sector is particularly influential. Canada’s currency is closely tied to the price of a barrel of oil. Oil is priced in U.S. dollars. This means that when the U.S. dollar declines against world currencies, the price of oil rises and the Canadian dollar goes up with it. Again, this makes a strong argument for Canadian based energy stocks.

To keep our dollar from rising too high, the Bank of Canada has kept short-term interest rates lower than it otherwise might have. The choice between very, very low rates on treasury bills and the risk of price declines from rising interest rates on longer bonds is unpalatable to most investors.

For our clients who have the scope to adjust their asset mix, we have recommended moving some of their fixed income portfolios into dividend paying stocks that have the capacity to increase their payouts to investors. Good examples of these are banks like CIBC (“CM”) and The Bank of Montreal (“BMO”) as well as telecoms and utilities like BCE Inc. (“BCE”) and TransAlta (“TA”). With the departure of most income trusts from the Canadian landscape, we have also added a number of Real Estate Investment Trusts (“REITs”) notably Retrocom Mid-Market REIT (“RMM.UN”) which stands to benefit from the takeover of Zellers by Target, the large U.S. retail chain.

For those clients with specific fixed income mandates, we have kept the portfolios mostly in short-term bonds. As always, these are guaranteed by the Government of Canada or the Province of Ontario. The upward movement in interest rates is not smooth because of all the political and geological turmoil in the world. Selectively, we have extended term out into 10 years bonds for brief periods when interest rates spike higher, in an effort to capture capital gains as rates ease lower.

## EXCHANGES

The last couple of months have seen several of the world's major stock exchanges become the subject of takeover bids (or merger offers) by foreign exchanges. The trend began with a bid by the Singapore Exchange ("SGX") for the Australian Securities Exchange ("ASE"). This combination has since been rejected by the Australian government but two others are likely to proceed.

On the same day in February, the Deutsche Börse ("DB") offered to merge with the New York Stock Exchange ("NYSE") and the London Stock Exchange ("LSE") made a similar overture to the Toronto Stock Exchange ("TMX"). To make matters even more interesting, the NASDAQ and the InterContinental Exchange ("ICE") have jointly submitted a competing bid for the NYSE whilst draping themselves in the American flag claiming that the iconic NYSE (which NASDAQ has always hated) cannot be allowed to fall into foreign hands.

In our opinion, it is probable that the TSX/LSE deal and some combination involving the NYSE will both proceed. The Australian market is more concentrated and the sale of the ASE to a foreign exchange could affect that country's capital markets; whereas both North American markets (as well as Europe's) are more fragmented. The political will to block the mergers is not likely to appear in Canada or the U.S. and it may be the best way for the two "iconic" incumbent exchanges, and perhaps all exchanges in the future, to prosper.

What is interesting in these merger discussions is how undervalued these profitable and growing exchanges are, even during a difficult period for the markets. The Chicago Board Options Exchange ("CBOE") is the exchange that benefits the most from volatility through hedging, based on its exclusive license on S&P 100 and S&P 500 Options and its proprietary Volatility Index ("VIX") which it has licensed to the Chicago Mercantile Exchange ("CME"). The CME remains the front-runner as a possible candidate to acquire the CBOE, but as the SGX, DB and LSE offers have shown, bids for Western exchanges can come from any corner of the globe.

## CONCLUSION

There will be no quick and certain solution to the resolutions in the Middle East or the nuclear crisis in Japan. Nevertheless, markets will assimilate the implications of these and will refocus on economic issues both globally and especially domestically.

Except for the U.S. housing market, the North American economy is strong which likely means that interest rates are heading higher. Investors with a need for income should look for dividend and distribution paying stocks and REITs with the potential to increase their cash flow. In sectors as different as communications technology and stock exchanges, there is cash available and an enthusiasm for mergers and takeovers which should provide market support for good companies which are undervalued.

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