Point of view

Straight talk on the markets

2010 Market recap

Trevor Greetham, *Asset Allocation Director and Portfolio Manager*

- While leading indicators recovered strongly and global growth rates peaked in early 2010, eurozone sovereign debt issues and a slowdown in global expansion during the summer months led to investors' fears of a double-dip recession.
- Toward the end of the year, however, global growth was greater than anticipated, due in large part to the decision by the Federal Reserve (the Fed) to provide additional stimulus in the form of QE2.
- Another positive factor for markets in late 2010 was rising business confidence, brought about in part by the recent U.S. midterm election results.
- Together, these two factors led to a rally in both stock and commodity markets.

Bob Swanson, *Portfolio Manager*

- Despite investors' fears of a double-dip recession in 2010, there was a continued appetite for risk, as evidenced by demand for higher-beta small-cap names.
- There was also an insatiable appetite for yield, particularly in Canada, where the focus was on income trusts. Even though income trusts were about to convert back to corporate status, which would almost certainly lower distributions and make yields less attractive, investors were still clamouring for these types of investments.
- Many investors were seen taking a barbell approach, adding some risk to their portfolios with small-cap stocks, in a search for growth and capital appreciation, and balancing this with the relative predictability of higher-yielding securities.

Commodities

Trevor Greetham

- Prices for commodities such as copper and aluminum are currently rising as a result of a widening global supply-demand imbalance.
- Though commodities may hold more potential than stocks, resource-producing regions such as Canada and certain emerging markets hold promise for equity investors.
- China has been trying to slow down, but that may take time. Meanwhile, demand for commodities in the U.S. is starting to pick up, with rising industrial production leading to more new orders, relative to inventories.
- There may be a point in the first half of 2011 at which China hasn't slowed enough and the U.S. starts to recover, which might boost Chinese growth further. This would be a bullish signal for commodities, but would also likely put pressure on China to tighten monetary policy to contain inflation.
- Continued strength in commodities will put upward pressure on yields. As yields rise, funds will likely flow out of fixed income and into equities and commodities.

Bob Swanson

- Metals and mining stocks continue to be favoured, given supply issues, particularly for metallurgical coal, which is used in steel production, and copper, which is used in building-related materials and automobiles, among other uses.
- Demand for auto fuel is starting to pick up, due to Chinese auto sales and growing oil consumption. That said, there is still spare capacity and supply in Saudi Arabia, so it is unclear how much demand will increase; $80–$100 per barrel is a reasonable price in the near term.

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Inflation

Trevor Greetham

- Spare capacity and high levels of unemployment will likely produce lower levels of core inflation in the U.S., resulting in a looser monetary policy on the part of the Fed.
- In China, however, inflation has been rising, fuelled in part by rising commodity prices, so further monetary tightening is likely.

Bob Swanson

- Inflation is affecting emerging markets more than developed markets; the latter have experienced food and materials price increases, but not wage inflation. We'll likely start to see wage inflation surface once unemployment levels come down. This should affect prices for consumer goods and services, as well as food and materials.
- Businesses will wait for a pickup in demand before beginning to spend and rehire.

Consumer and business demand

Trevor Greetham

- Emerging market consumer demand has remained strong. However, there have been signs of rising demand elsewhere, particularly the U.S. and U.K., where strong retail sales data over the last few months have proved a pleasant surprise.
- In Germany, consumer and investment demand have also risen, as a result of very low eurozone interest rates. Doubts about the stability of the European monetary union could further weaken the euro, providing a boost to German exporters.
- Local demand will still be a driving force in China, but exports are also likely to strengthen on the back of rising U.S. consumer spending.

Gold

Bob Swanson

- In general, gold tends to thrive in both inflationary and deflationary environments. However, if we have moderate, steady recovery, with a strengthening dollar and no major economic crisis – which may be where we're headed – the probability is that gold will not perform well.

Trevor Greetham

- Also, as the recovery continues, investors will likely turn to industrial commodities, such as copper, rather than the safe haven of gold.

European sovereign credit risk

Trevor Greetham

- Politics will likely play a large part in resolving this issue. The risk is that the European Central Bank (ECB) will be forced to print more money, thereby weakening the euro.
- Germany's economy is stronger than the rest of Europe and should remain so, even if the country has to bail out other economies. Plus, exports will benefit if the euro weakens.
- From a macroeconomic perspective, improvement in Spanish property prices could herald a significant recovery in peripheral markets' bond and financials sectors. However, if property prices drop further, the crisis may intensify.

Canadian dollar

Bob Swanson

- The strength of the Canadian dollar has certainly hurt the Canadian manufacturer. The reality is that manufacturers may have to learn to live in an environment in which their currency is going to be stronger, and introduce hedging programs or sourcing programs as an offset.

Straight talk on the markets

- Still, we believe that as long as the commodity cycle remains strong, and as long as the Canadian economy is growing faster than the U.S., there will be continued support for the Canadian dollar.

Central banks

Trevor Greetham

- As an economic recovery takes hold, central banks will look to reduce or reverse some of the extraordinary stimulus and monetary policies implemented as a result of the financial crisis. While the timing is not known, central banks could sell the fixed-income assets they had been buying or raise interest rates in order to control inflation. The latter is more likely, as central banks will probably hold fixed-income assets to maturity.
- Given the existing spare capacity observed in the U.S., the Fed will likely maintain a looser monetary policy this year; its main focus is core inflation, which at the moment remains low.
- The ECB, however, which is more concerned with headline inflation, may raise rates.

Bob Swanson

- The Fed has focused on stimulating the economy and increasing liquidity. The next step is to provide incentives to get the money out of the banks and into the economy through loans. If bank lending increases, the Fed can begin to back off on quantitative easing.

Key takeaways

Trevor Greetham

- In terms of where we are, it's a world of short, volatile economic cycles. Therefore, the approach is to keep a broad asset allocation exposure; otherwise, short-term market timing can hurt portfolios.
- In regards to options for the marginal money, in the last three months the shift has been towards resource sectors, and away from defensive sectors such as health care and telecoms. And the more appealing places for overweight money in emerging markets are Latin America and South Africa.
- Finally, with the recent market's short-term but steadily rising trajectory, if there is a correction based on eurozone concerns, it's a time to buy.

Bob Swanson

- Stocks should be preferred over bonds, particularly Canadian stocks with commodity exposure.
- With interest rates at an all-time low and poised to move higher, reasonable equity valuations and both the economy and corporate earnings beginning to recover, equities are well positioned to benefit.
- A particular focus will be on large caps – multinationals that are leveraging the growth in emerging markets, have a strong dividend yield and are buying back stock and increasing their dividend over time.

Source: Fidelity Management and Research Company

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