

Mini boom or bump and grind?

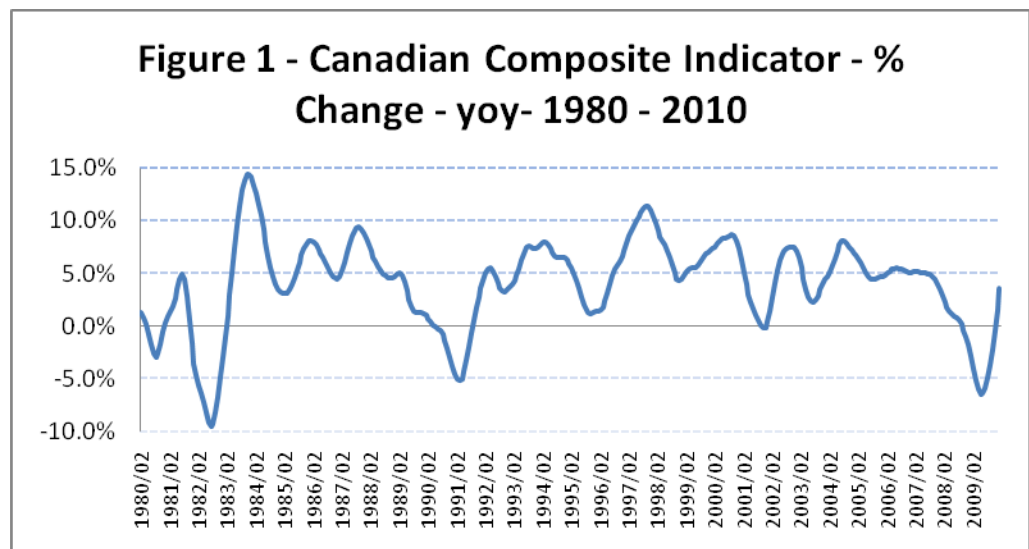
The past quarter has been a good one for Canadian equity investors in a quiet, low-key sort of way. Corporate earnings have been strong, economic releases have been generally positive and the exogenous shocks that have occurred, such as the Greek debt crisis, have been handled by the global finance community with relative ease. Against this backdrop the TSX has risen about 3.0% this year which is a satisfactory return if annualized and also quite attractive in relation to fixed income returns. Looking into the rest of 2010 and even as far out as 2011, I continue to see an economy and stock market that offers a positive trade-off in terms of risk and reward. It is my view that we have just entered Year 2 of what I expect will be a five to seven year economic and stock market up cycle. After last year's huge market snap back rally, a bit of a pause to absorb last year's gains is probably in order. However, I expect that the bump and grind of the market over the past 3-4 months will eventually give way to a much more buoyant market later this year.

As was the case at the start of the year, my bullishness stems from both macroeconomic and microeconomic factors. On the macroeconomic front most domestic economic indicators point to an even more robust economy in the second half of 2010 than that which we have experienced so far this. At the same time, the outlook for inflation and therefore interest rates still remains tepid. Market valuations, the relative strength of Canada's banking industry and our stable democracy all provide the supporting arguments for a market that I think will be much higher in a year than it is today. At the microeconomic level, my bullishness is even more emphatic. This is because I am first and foremost a bottom-up investor and I continue to have little difficulty finding companies to invest in that are growing at 20% per annum or more and with forward P/E ratios that are significantly less than 10x.

Substantiating my bullishness

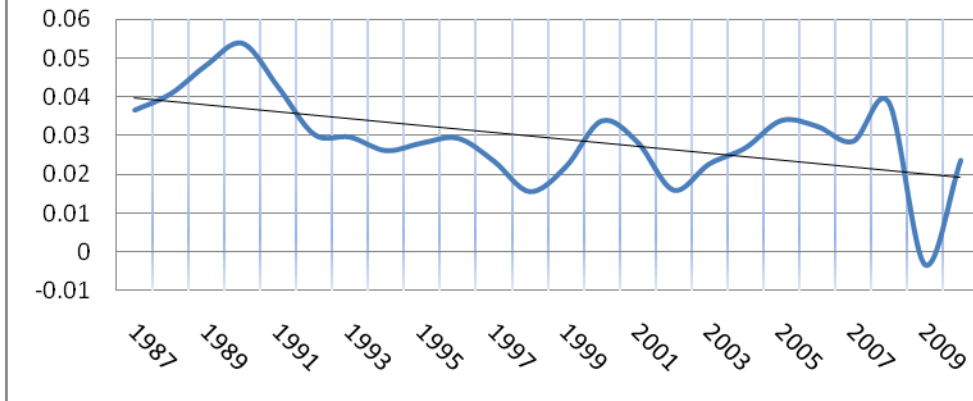
As a bottom-up investor, I don't spend a significant amount of time looking at macroeconomic data. That said I do track a couple of statistics that give me a feel for the types of risks and opportunities that lie ahead for the economy and stock market. My favorite economic release to follow is the composite leading indicator (CLI) which is compiled and reported on a monthly basis by Statistics Canada and consists of ten sub-indicators that point to where the

economy will be in 6-12 months time. Investors should note that the stock market is one of the 10 components of the CLI, so one needs to remember that the CLI is a predictor of the economy not the stock market. Figure 1 below shows the annual percentage change in the Canadian CLI over the past 30 years, and it shows that over this time frame Canada has experienced 3 serious drops in economic activity, including the one that occurred in 2008 and 2009. Looking into 2010, I see the CLI rising sharply from a very severe trough and draw the following three conclusions. First, all things being equal, the ultimate bounce in the CLI should be higher than average given that it is coming from a particularly low trough – this has been the historical pattern. Second, based on the movement in the CLI that has already occurred this year, I expect that economic activity in the second half of 2010 will be stronger than what we are experiencing today – i.e. the economy is not simply strong, it is strengthening. Finally, if the CLI keeps rising for another month or two, which I expect will occur, we will soon start to see a sharp upward revision of 2011 corporate profits and this I believe will set off the next up-tick in the stock market.



Of course, the cold water that can be thrown on all of this bullishness is inflation, and indeed with commodity prices moving up, the threat of inflation does bear some warning. However, as we see in Figure 3 inflation is still at the low end of the historical range and the trend line remains negative. Indeed, while commodity price inflation is a real issue, so is unemployment and excess capacity in certain segments of the economy. As such, I believe that inflation needs a much bigger uptick in economic activity and employment to be a serious concern. Higher inflation is therefore a risk that I will monitor but not act upon for the foreseeable future.

**Figure 2 - US Inflation 1987 - 2010 - US
Bureau of Labor**



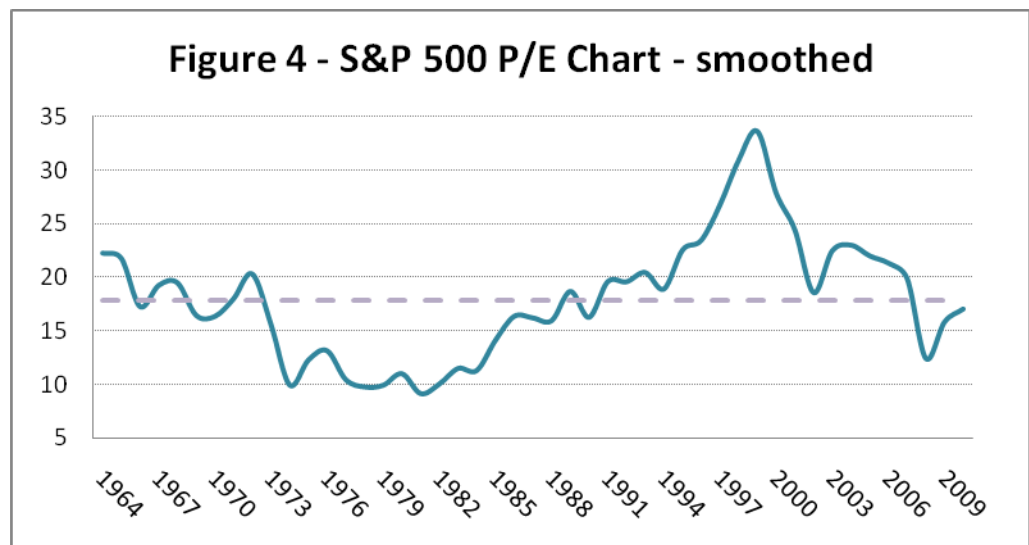
Reinforcing my bullishness on the Canadian economy is the yield curve which gives a fairly good measure of the market's appetite for risk and a fairly accurate reading on where the economy is heading. Historically, the yield curve has been a good predictor of future economic activity in other countries as well as Canada and while the yield curve has flattened slightly since the start of the year, the slope of the yield curve and the absolute level of both short and long term interest rates remain extremely accommodative to economic growth. Once again, I view the steepness of the yield curve as a good predictor of future economic activity and today it suggests that stronger economic activity should be expected.

**Figure 3 - Canadian Yield Curve - 10 Yr GOC -
2 Yr GOC yield - 1997 to 2010**



The final macroeconomic factor that I look at only a fairly regular basis is valuation. As I have written before, long-term valuation data for the broad market in Canada is unreliable for a variety of reasons and thus I tend to favor

US data when looking at long-term trends. While valuation is generally not a good timing device, valuation does provide us with some measure of the risk versus reward opportunity. Figure 4 below shows the P/E Chart for the S&P 500 going back to 1964. This figure also uses the five year average earnings as the denominator in calculating P/E for the S&P 500. The reason for this is we are trying to eliminate the volatility in earnings that occurs over the course of the business cycle. My interpretation of figure 4 is that it shows we have experienced a massive correction that started with the “tech bust” in 2000 and culminated with the market bottom of 2009. Valuation is now once again reasonable, particularly when we take into account the cost of government bonds. While not a timing device, Figure 4 shows that the market’s current valuation is in the mid-range which suggests that investors entering the market in 2010 should expect returns on a go-forward basis to equate to the markets long-term returns of 10-11%. Interestingly, on an annualized basis that is roughly what the TSX is on target to achieve in 2010 based on the first 3 and half months of the year.

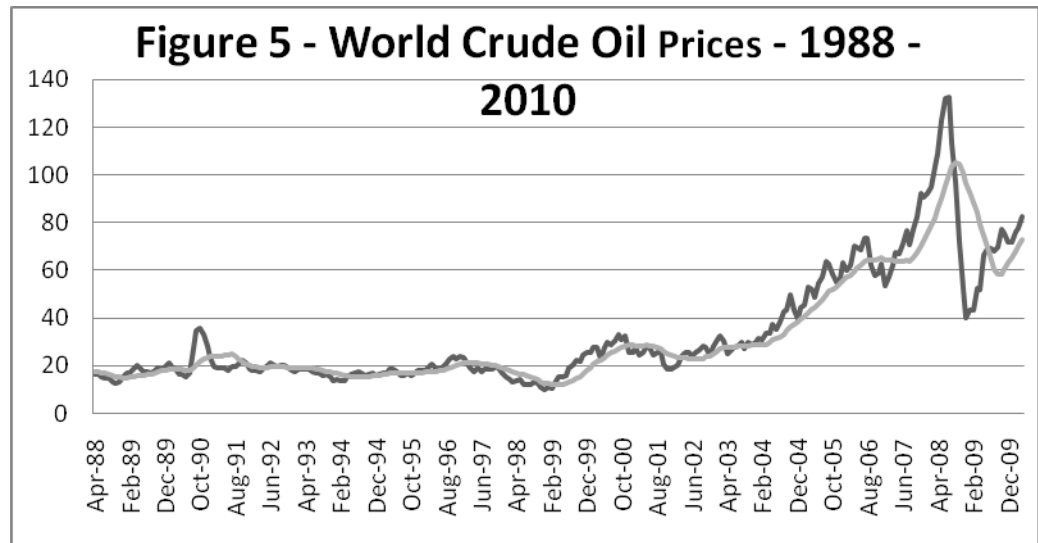


A stock market is a market of stocks

As we enter the second quarter of 2010 I see value in many places, but three sectors of the stock market stand out as having particularly rich pickings. First, I am an energy bull and believe that ongoing global economic growth will lead to higher energy prices. Second, I believe that financial service stocks in Canada with a link to the domestic real estate market are particularly undervalued. Finally, I continue to own several emerging franchise stocks that are still underappreciated by investors and which I expect will provide the basis for some terrific long-term returns.

My thesis on energy is straightforward. First, I am bullish on energy but unlike other commodities such as base metals, precious metals and agriculture commodities, I see the supply versus demand argument with energy to be

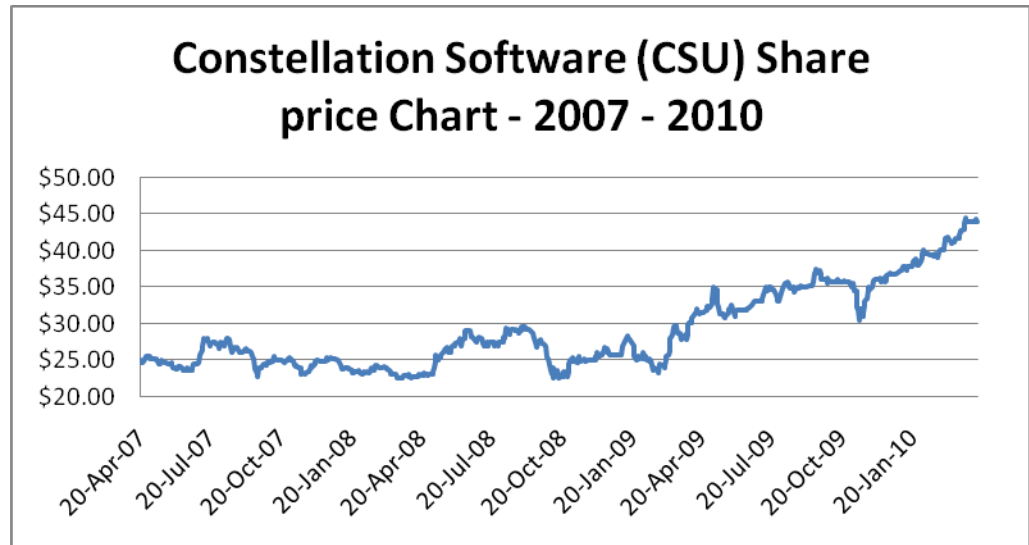
much simpler and easier to understand. The amount of oil that can be profitably extracted at \$80 a barrel or less is finite and depleting rapidly, while no viable substitute exists in the short-term. Second, I continue to find many producers in both Canada and internationally that are very profitable at current oil and natural gas prices. If oil and gas prices go higher they will become even more profitable. Finally, most of the companies that we own are in the midst of significant exploration and production ramps and should see sharply stronger earnings in 2011 even if energy prices plateau at current levels. My favorite names in the sector include **Pacific Rubiales**, **Rock Energy**, **Terra Energy** and **Petrobank Energy**.



The second area of focus in the Capital Ideas Fund and the core focus of the Financial Services Venture Fund are financial services stocks with exposure to the “Canadian” real estate sector. Canadian financial services companies operate in oligopolistic clusters which limit competition and therefore result in high ROE’s for investors. At the same time, the Canadian real estate lending industry is arguably the most conservative and heavily regulated amongst the G20. Thus, Canadian banks and mortgage lenders operate within extremely stringent loan-to-value and proof-of-income standards. I regard companies such as **Home Capital**, **Equitable Trust**, **Altus**, **Genworth** and **First National** as some of the best managed and inexpensive equities in Canada and we continue to own these stocks in size.

The final area of focus for the Capital Ideas Fund are stocks which I call “franchise” stocks. These stocks fit no particular theme other than the fact that they are extremely well managed companies, have significant free cash flows, strong balance sheets and enjoy competitive advantages that allow each to generate high margins and returns on equity. Key franchise names in our view include **Constellation Software**, **Logibec**, **MTY Food Group**, **Distinction Group**, **Total Energy Services**, **Alliance Grain Traders** and **Paladin Labs**. While many of the commodity stocks in our portfolio come and go largely as a result of shifting valuations, franchise stocks are purchased with the intention

of never being sold – it doesn't always work out that way but that is the intention. We also believe that growth investors who are not following the market on a day to day basis would be best served by investing in companies like the seven mentioned above.



Concluding remarks

Both the Capital Ideas Fund and the Financial Services Fund have had a good start to the year and have outperformed the market. While the markets typically quiet down over the summer I sense that this year the market may hold up well through the May to September period. We think now is a good time to be adding to either fund as we sense that the markets will continue to perform well. Call me if you want to chat – J.P. Donville – 416 – 364 – 8886.