

## Post Traumatic Stock Market Syndrome

I believe that the global economy is much healthier today than many market pundits would have you believe. While much of the global economy is digging itself out from a severe “balance sheet” recession, the worst is almost certainly behind us. However, I also believe that stresses and fears relating to the near economic collapse of 2008 are still fresh on everyone’s minds and this tends to affect the way we view all events in the market. Psychologists call this the recency effect which is the tendency for us to remember or emphasize our most recent experiences.

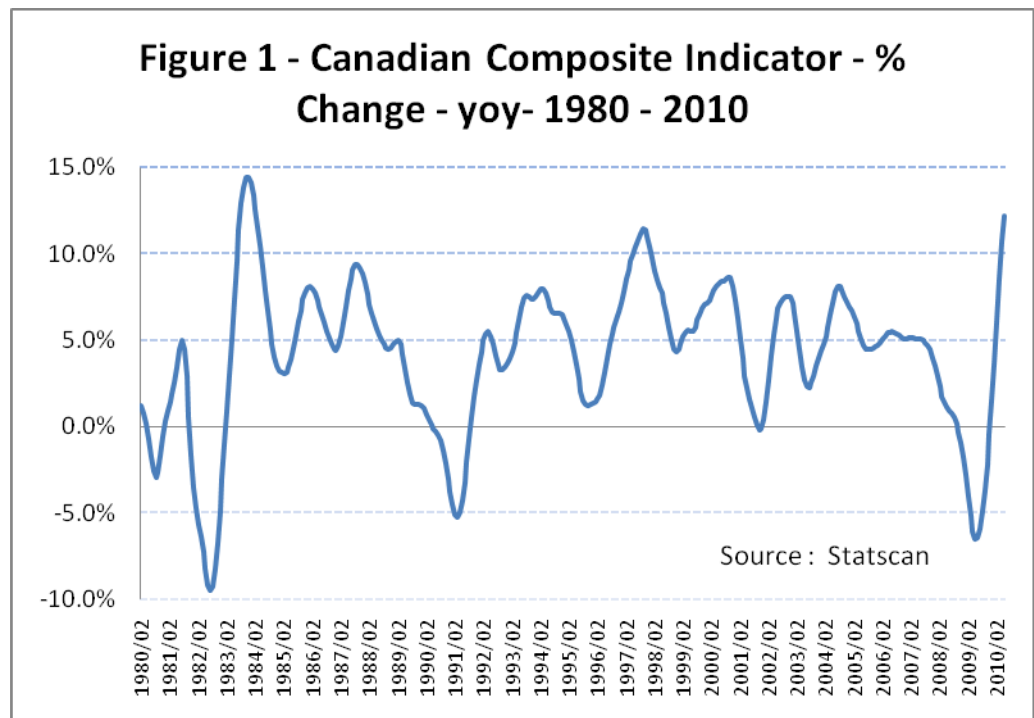
So how likely is a return to economic conditions that we experienced in 2008? In my view it is not very likely! The best way to understand what has happened in the global economy over the past decade is to look back at our own economic history. For Canada, the 1980’s were a period of rapid economic growth, financial services liberalization, and sharp asset price appreciation particularly in the real estate segment of the economy. However, once the bubble burst the inevitable real estate crash ensued that resulted in the failure of most of the Canadian Trust industry and serious concerns about the viability of our largest banks.

At the same time that our real estate industry was getting slaughtered the rest of the economy was in pretty bad shape as well. In 1993 Canada’s budget deficit and debt-to-GDP ratios were among the worst in the G7. At that time, the Liberal government of Jean Chretien put forward an austerity program that sought to get Canada’s fiscal house in order. Would you invest in an economy that looked like ours did in 1993?

Most western economies look today like Canada did in 1993 or 1994 but in hindsight this turned out to be a great time to invest in Canada. In 1993 most of Canada’s large banks were trading at book value per share, and the overall stock market was trading at a single digit P/E ratio – both extremely cheap by historical measure. Yet we now know that by 1998 the Chretien Government had balanced the books and achieved most of its economic goals and along the way, the Canadian stock market performed extremely well. The recency effect that was in play in 1993 did you no favors – you should have been “long” the stock market yet many investors were certain that things would only get worse and kept their money under the mattress.

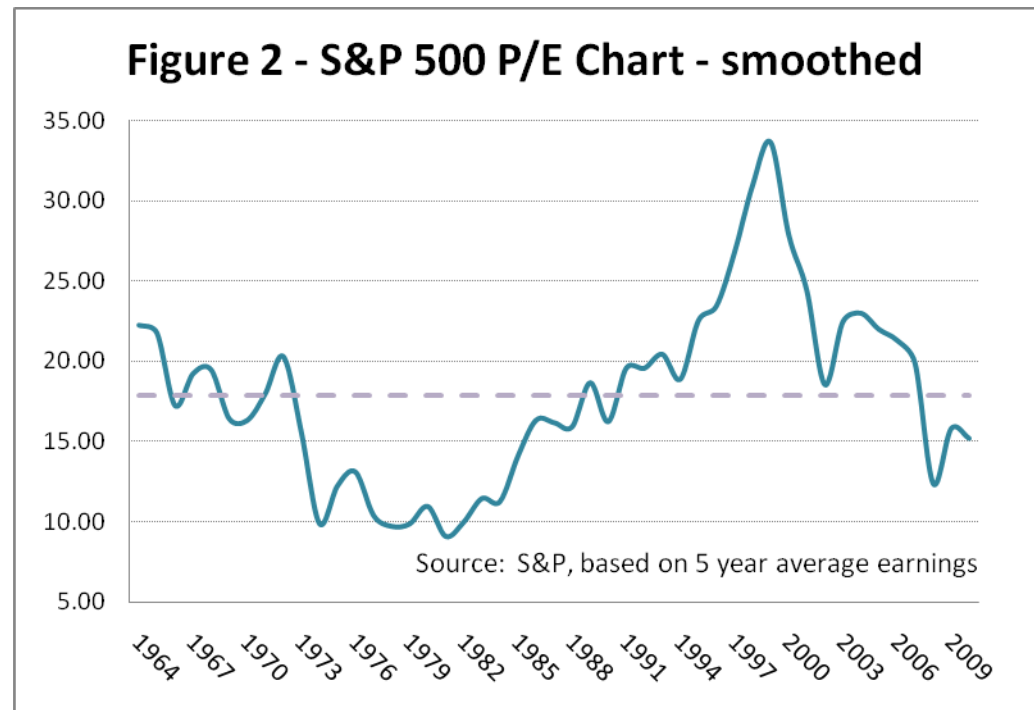
Now back to 2010. When we compare what happened in Canada in the early 1990's and what has happened in the US and Europe over the past 3-4 four years we see a similar pattern. An asset bubble leads to a crash, many leading financial institutions fail before the government jumps in to recapitalize the rest, and austerity programs are implemented to restore balance to the economy. This is roughly what happened in Canada in the 1990's and this is what has happened or is in the process of happening in most western countries today. And just like back in 1993 or 1994, I think today is another good time to invest.

Of course, the other thing that makes investing in Canada particularly interesting is that while most western countries look like Canada did in 1993, Canada has rarely looked better. Currently, our banking system is fully cashed up, Federal and Provincial balance sheets look reasonably strong, employment is solid, and the composite leading indicator is sitting at its highest level in terms of year over year growth in 30 years. Don't believe the pessimists – the world and Canada are not perfect but the pessimism you have been hearing about is overdone.



Of course, while we “talk the macro talk”, we actually “walk the micro walk”. By that we mean that our core investment strategy involves making relatively large bets on a small group of companies. We continue to view Home Capital, Constellation Software, Alliance Grain, MTY Foods, Altus Group and Paladin Labs among our favorite holdings. Sadly, we must say goodbye to Montreal based Logibec, which up until a few days ago was a 6% holding in our fund. Logibec received a take-out offer at \$26.00 a share and the Company is now owned by OMERS. Notwithstanding the departure of Logibec, we continue to find many superb businesses trading at reasonable valuations. And while we don't hold any major positions in US stocks at this time, a combination of

rising earnings and modest stock market gains make the S&P an attractive place to invest relative to historical valuation metrics as well. We think Canadian and US markets are heading higher.



So what should we expect for the rest of the year? Our expectation is that Q2/10 earnings season will lead to earnings revisions for both 2010 and 2011 that will take the market higher. Indeed, the leading economic indicator we presented in Figure 1 tells us that in addition to a strong second half of 2010, the first quarter of 2011 should also be strong. Further, with interest rates low and valuations modest, I believe there is a one in three chance that we could have a very big move upward in the market over the next six months.

There is too much pessimism out there which flies in the face of both history and data. Warren Buffett has often said “be greedy when others are fearful and fearful when others are greedy”. The markets collective fear means now is the time to be an investor.

Call me if you want to chat – JP Donville – 416 – 364 - 8885