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## ◆ *Sharp Asset Management Inc.* ◆

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### Quarterly Investment Review – December 2010

#### **U.S. Policy Stimulus Drives Capital Markets**

Global stock markets reacted positively to the Federal Reserve's quantitative easing announcement along with the passage of an extension of the Bush tax cuts. The MSCI World Index rose 6% during the fourth quarter, the TSX gained 10%, Emerging Markets 4%, EAFE 3% and S&P 500 7%. 2010 returns are: World 7%, TSX 18%, EM 13%, EAFE 3% and S&P 500 9%. (All results are in Canadian dollar terms.) Materials, health care and consumer discretionary had the largest annual gains while technology, energy and staples lagged. Once again, the returns for small caps were better than large caps. (This is a global phenomenon.) Bonds were down 1% during the quarter but, returned 7% for the year. Cash earned .2% during the quarter and .5% over the last year.

#### **Global Growth to Slow Modestly in 2011**

2011 global economic growth (4.2%) is expected to be a little slower than 2010 (4.8%) as policy stimulus is reduced in many nations. (*Forecasts are from the International Monetary Fund World Economic Outlook (WEO) Recovery, Risk and Rebalancing October 2010.*) The big exception to this is the adoption of additional monetary and fiscal stimulus in the U.S., the largest economy in the world. *The U.S. economy will be one of a very few to post a higher growth rate in 2011 than 2010.* To put the stimulus into perspective, the size of the U.S. economy is about \$14.8 trillion. The combined packages are \$1.458 trillion or equivalent to almost 10% of GDP. These programs will keep interest rates lower than normal thereby reducing debt servicing costs, increase after tax income and increase unemployment benefits so consumers have more money in their pockets. Policymakers are hoping that growth will be sufficient to bring down unemployment and enable the economy to gain enough traction to sustain growth without stimulus. An excess supply of housing which continues to put downward pressure on prices, conservative bank lending practices and high unemployment are obstacles to growth in the U.S.

Contrast the American situation with Europe; monetary policy remains on hold while fiscal policy is becoming restrictive. A number of countries in Europe are running unsustainable budget deficits and have high levels of debt outstanding. The European debt crisis is forcing countries to deal with this by tightening government purse strings. The ad hoc response to each country's financial crisis has put downward pressure on the euro. The weakness in the euro has enabled Germany to expand exports to emerging markets and its economy is booming. Growth in Germany is expected to moderate this year as its export customers experience slower growth. This fall, Ireland was forced to accept EU and IMF loans of 67.5 billion euros. Portugal could be next and concerns about Spain remain. The threat of further debt restructuring in Europe is a risk to the global economic outlook. Undercapitalized banks and weak real estate markets in some countries are restraining growth in the eurozone.

Among the emerging countries, growth rates have been strong and inflation has increased. In China, authorities are tightening monetary policy and allowing the yuan to increase slightly in an effort to cool the economy and control inflation. Other Asian countries such as India are also increasing interest rates to keep inflation from rising. Monetary policy is a blunt tool; there is always a risk that central banks tighten too much or not enough. A more pronounced slowdown in the developing economies than expected would threaten the global expansion.

#### **Capital Markets Expectations**

We have increased our target for the TSX Composite to 14,200 over the next twelve months. Strong economic growth from developing countries is translating into higher commodity prices. This has boosted our earnings forecast and thus our stock index value. Interest rates are not expected to increase substantially for another year until there are convincing signs the global economy has gained traction. This is supportive of current valuations.

Bond yields will likely move up in 2011 as the U.S. economy responds to more monetary and fiscal stimulus. Low inflation will limit the rise in yields.

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The Bank of Canada is in a tricky situation. Ultra low interest rates are enticing consumers to pile on debt yet further increases in the bank rate are likely to push up the loonie and this is harmful for manufacturers. Carney will likely wait until late in the second quarter before raising rates again.

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