

# Economic Comment

Second Quarter 2011

## **“Black Swans”**

Black Swans is not the name of a new Australian merlot but a new term in the lexicon of economists and investors. These are unusual events that happen from time to time. During the first quarter we have had a flock of black swans landing on the stock market. The good news is they did not have a negative impact. The S&P/TSX Composite Index returned 5.6% and the American S&P 500 returned 5.9%.

The Japanese earthquake, tsunami and nuclear crisis has been devastating to that country however, the impact to the global economy is small. There have been manufacturing supply chain disruptions particularly in the auto sector. The expectation is that while the short term outlook for economic growth will be significantly reduced, the recovery and rebuilding activities which follow will spur future growth.

The crisis in North Africa and the Middle East has greater potential for global growth disruption if it spreads to Saudi Arabia. The countries engulfed in these revolutions are small and have little significance in global growth except for oil. Investors have been concerned that oil supplies would decline and the price would increase. The decline in oil supplies has been small and other members of OPEC have already compensated. However, the price has increased from \$80-90 per barrel to \$100-115 due to speculators. One thing we believe will happen in the longer term is that the oil will continue to flow from these countries based on the need for revenue.

The last black swan to land is the debt default of Portugal. They have asked the IMF and the EU for financial help. To some extent, this event was expected. Portugal now joins Greece and Ireland as dependents on the global financial system. Investor concern has now turned to Spain which has had a number of failures in small saving banks (similar to Credit Unions). Spain's problem is the same as Ireland's as they overbuilt real estate and used too much borrowed money. It is not known at this time how good or bad the financial situation is in Spain. The fear is a Spanish debt default could cripple the rest of Europe due to its size.

Looking past these negative short term events, the global economy is expected to grow at a respectable 4.4% rate in 2011 and 4.5% in 2012 (IMF). The U.S. economy is expanding at a moderate rate of 2.5% to 3.0% in 2011 and 2012 due to low interest rates and government spending. China and other emerging economies have continued to grow at a faster pace than advanced economies which has provided the strength to the global economy. However, inflation is also growing at double the rate of the advanced economies. Their governments have taken steps to reduce growth to contain inflation.

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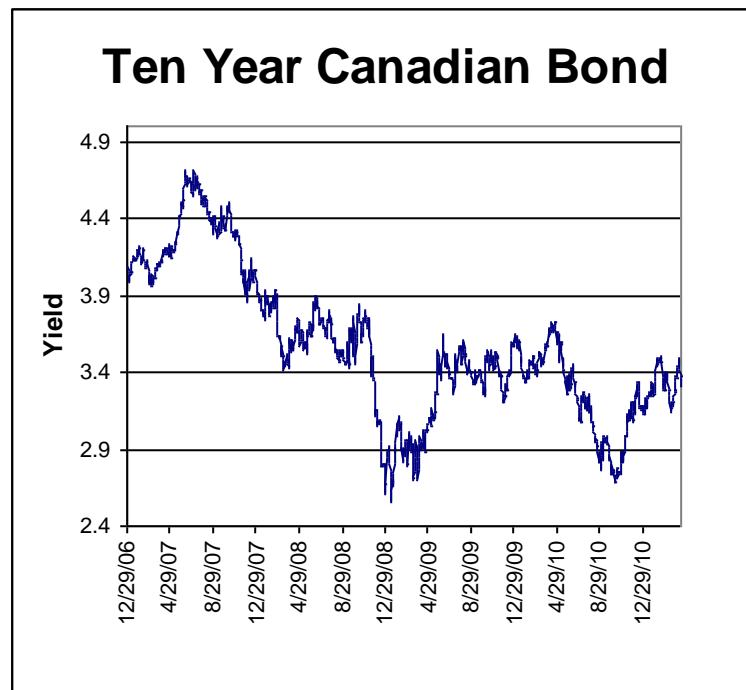
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While the rise in oil price is not a black swan but a result of the conflicts in the Middle East, it is having a negative effect on economic growth. If the oil price remains high (over \$100) for a prolonged period of time it will act as a tax on consumers and divert money away from discretionary spending.

In Canada, the higher oil price has raised the value of the Canadian dollar above parity with our largest trading partner. Clearly, this will have a negative affect on our export of manufactured products. The Bank of Canada will be taking this negative impact into consideration when it makes decisions to increase the Bank Rate. We believe the Bank of Canada will raise the Bank Rate in the second half of 2011 slowly to 1.75% to 2.0% by year end.

With global inflation rising due to higher commodity prices, we believe the yield on 10 year Government of Canada bonds will increase slightly from 3.3% to 4.0% by year end. We have increased our target level for the S&P/TSX Composite Index to 14,800 over the next 12 months. Given relatively low interest rates and improving corporate earnings, particularly in commodity producing companies, we feel this target is reasonable.



Source: Globe and Mail

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