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Quarterly Investment Review – March 2011

Stocks Rise and Bonds Fall as Economic Growth and Inflation Speed Up

Global stock markets reacted positively to signs that policy stimulus is boosting the U.S. economy. The MSCI World Index rose 3% during the first quarter, the TSX gained 6%, Emerging Markets 0%, EAFE 1% and S&P 500 4%. For the last twelve months the returns are: World 9%, TSX 20%, EM 14%, EAFE 6% and S&P 500 11%. (All results are in Canadian dollar terms.) Energy and health care had the largest gains while technology, utilities and staples lagged. Bonds were *down* .3% during the quarter but, returned 5% for the year. Cash earned .3% during the quarter and .8% over the last year.

Downside Risks to Global Economic Outlook Increase

Two significant, unforeseen events in the first three months of this year have the power to alter the global economic outlook significantly. The devastating earthquake, tsunami and nuclear crisis in Japan have taken a shocking human toll and in the near term, there will also be an economic toll. Disruptions to the global supply chain (most notably felt in the auto and electronics industries) will have a negative impact on growth in the first and second quarters. After that, reconstruction in Japan should boost the economy.

The political instability in the Middle East and outright civil war in Libya have caused oil prices to increase about \$20 per barrel since the start of the year. This is like an immediate tax on consumers and businesses. If oil prices stay below \$125/bbl, we do not expect the growth outlook to change. If they go towards \$150, growth will be reduced significantly. In the event that production in Saudi Arabia becomes seriously constrained, oil could soar towards \$200/bbl. This could push the global economy into a recession.

We continue to monitor the European sovereign debt crisis which remains a serious risk to the global economic outlook. Last week, Portugal became the third country after Greece and Ireland to request financial aid. Portugal has debt maturing in the next few months that it must refinance (it doesn't have enough money to pay it off). The rates on borrowings in the marketplace are so high that it is better to borrow from the IMF and EU because the rates are much lower. In order to qualify for these loans, Portugal will have to implement austerity programs. Markets barely reacted to the news about Portugal because it has been expected for months. If the crisis remains contained to these three countries, the outlook for the global economy and equity markets will remain promising. However, if the crisis engulfs Spain, the impact on the investment environment would be extremely negative.

So far, we have focused on the downside risks to growth. Where are the areas of strength? China remains one of the strongest contributors to global growth and we are encouraged by recent developments there. The central bank has continued to tighten monetary policy and there are now indications that it is having the desired effect of slowing growth, particularly in the housing sector. Inflation is running high in China due to the increase in food and energy prices. By allowing the yuan to appreciate modestly and wages to rise in order to limit the impact of higher inflation on consumers, the economy is becoming more balanced. Domestic growth is increasing faster and the trade surplus has shrunk.

There has been a sigh of relief as the latest data from the largest economy in the world, the U.S., has been released. The stimulus is working—manufacturing is running at high levels and consumer spending has been surprising on the upside yet the savings rate remains steady. Unemployment is coming down and there has been steady job growth of late. Exports are booming. The weak spot remains housing and will likely remain so for at least another year.

The latest report from the IMF reflects these cross currents in the April 2011 World Economic Outlook "Tensions from the Two-Speed Recovery". The IMF is calling for world GDP growth in 2011 of 4.4% and expects 2012 growth of 4.5%. Advanced economies are predicted to grow 2.4% and emerging economies 6.5% this year.

Capital Markets Expectations

We have increased our target for the TSX Composite to 14,800 over the next twelve months due to higher earnings expectations. The rise in oil prices is having a positive impact on earnings in the energy sector while higher gold and agricultural prices are also boosting the profit outlook. Interest rates are still not

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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 continue to move up in 2011 as the U.S. economy responds to more monetary and fiscal stimulus. Low inflation in Canada and the U.S. (outside of food and energy) will limit the rise in yields. It is only when higher food and energy prices begin to be reflected in higher wages that inflation becomes a serious problem. This is unlikely to happen due to high unemployment rates in the developed world.

The Bank of Canada is expected to raise short term interest rates this summer. 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. A wild card in the outlook is oil prices; if they move substantially higher, the Canadian dollar would also rise and this could limit Carney's room to maneuver on interest rates.

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